THE SEC PROPOSAL ON MARKET STRUCTURE: HOW WILL INVESTORS FARE?

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

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THE SEC PROPOSAL ON MARKET STRUCTURE: HOW WILL INVESTORS FARE?

Tuesday, May 18, 2004

U.S. House of Representatives,
Subcommittee on Capital Markets, Insurance and,
Government Sponsored Enterprises
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to call, at 2:03 p.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ryun, Fossella, Hart, Brown-Waite, Kanjorski, Ackerman, Inslee, Moore, Hinojosa, Lucas of Kentucky, Crowley, Baca, Miller of North Carolina and Velazquez.

Chairman Baker. [Presiding.] I would like to call this meeting of the Capital Markets Subcommittee to order. This is the subcommittee's fourth hearing in this Congress on the subject of U.S. capital market structure. Our first hearing on corporate governance issues was conducted in New York and examined the regulatory role of the exchanges and the potential conflicts of interest that are created by self-regulation.

The second examined reforms that potentially would enhance competition in the securities markets. The third focused on reform efforts at the New York Exchange and the role of the specialist system in a technologically revolutionized marketplace. The 211-year-old NYSE is the leading auction market in the United States. In my judgment, it has worked very effectively throughout the years in providing for capital expansion needed for our economic growth.

The NASDAQ market is an inter-dealer quotation system established in 1971. Over-the-counter securities and NYSE-listed stocks may also trade through NASDAQ. Dealers quote, bid and ask prices and the NASDAQ computer system integrates the quotations, calculates the best bidder offer, and displays the prices on screens. The development of electronic communications networks, ECNs, that link institutional investors so they can trade directly with each other revolutionized equity markets. They diminished the role of the specialist by allowing users to enter orders at specific prices and execute them automatically against other orders.

The trade-through rule is the subject of discussion and a somewhat controversial provision that has been recently addressed by the SEC. The rule states one market cannot trade at prices inferior to a price displayed by another market. Critics of the rule analogize it to requiring a consumer to purchase ice cream at a store across

town which sells ice cream at a slightly lower price than a store located closer to the consumer. Opponents of the trade-through argue the NYSE holds a dominant position in the global marketplace not because of superiority of service, but because of the coercive power of this rule.

Instead of instantaneous computer-to-computer transactions, the trade-through rule causes a delay for up to 30 seconds in the execution of investor orders, in some cases a very significant delay to the consumer's best interest. In fast-moving trading, brokers find that the NYSE price fluctuates during the time it takes for execution. The reality is that the inferior price that calls the order to be routed to the exchange may be a better price once the order is received by the NYSE specialist.

The SEC proposed a reform of the rule that expands the reach to include NASDAQ, but would relax the rule in ways that would favor, could possibly, electronic markets. The theory behind the proposal is that speed and anonymity of execution should take precedence in trading and competing markets should be able to ignore potentially superior price if it slows down execution. So far, even the New York Exchange appears amenable to the modification that would allow for fast markets to trade through slower markets within certain limits, because they hope to bring greater automation to its own trading floor so it can fall within the definition of a fast market.

However, the NYSE is opposed to allowing consumers to opt out of the trade group. They argue that the opt-out may compromise the quality of executions that investors receive. ECNs argue that the opt-out is necessary because the so-called "best available price" is not always accessible.

The conclusion I have reached is that executing an order at the best price is certainly a laudatory goal and should be the principal mission which the exchanges engage in regardless of the site of execution. However, it is clear to me that in today's marketplace, trades executed through the NYSE do not always automatically reflect best price. In fact, on as many as thousands of occasions in a given week's trading, best price may be offered on a competing exchange and the order not appropriately routed, given current technological constraints.

And in my judgment, the buyer should be the determining factor in how the trade is executed. Whether best price is the most important to their trading perspective or whether other considerations take precedence should be left to the consumer's best judgment on an informed basis.

For these reasons, I am anxious to hear the testimony of those who have agreed to participate in today's hearing. I believe this to be a most important issue facing the committee and the Congress. It is certainly significant in the overall capital formation of our American capitalistic system and we hope to come to the most appropriate conclusions based on the best advice we can receive.

With that, I call on Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

We meet for the fourth time in the 108th Congress to review the organization of our capital markets and evaluate the need for further reforms in light of technological advances and competitive de-

velopments. This hearing seeks to examine how the market structure changes recently proposed by the Securities and Exchange Commission will affect investors.

As I have regularly observed at our previous hearings, a variety of agents in our equities markets have questioned one or more aspects of the regulatory system during the last several years. We have also, in my view, come to a crossroads in the securities industry, confronting a number of decisions that could fundamentally alter its organization for many years to come.

We have elaborately interconnected systems and relationships in our equities markets. I therefore believe that we should heed the philosophy of Edmund Burke and refrain from pursuing change for change's sake. We should only modify the structure of our securities markets if it will result in improvements for investors. The Chairman of the Securities and Exchange Commission has recently observed that in pursuing any change to fix those portions of our markets experiencing genuine strain, we must ensure that we do not disrupt those elements of our markets that are working well.

In February, the Commission put forward for discussion four interrelated proposals that would reshape the structure and operations of our equities markets. Because these proposals have generated considerable debate, the Commission announced last week that it would extend the public comment period until the end of June.

In adopting the Securities Acts Amendments of 1975, the Congress wisely decided to provide the Commission with a broad set of goals and significant flexibility to respond to market-structure issues. From my perspective, this legal framework has worked generally well over the last three decades. It is also appropriate for the commission at this time to review its rules governing market structure and for our panel to conduct oversight on these matters.

Mr. Chairman, as you already know, I have made investor protection one of my highest priorities for my work on this committee. Although many of the agents in our securities markets have called for adopting market-structure reforms and some of them may benefit from these changes, the commission must thoroughly examine the effects of its reform proposals on average retail investors before approving any change.

Today, I suspect that many of our witnesses will discuss the Commission's proposal to alter the trade-through rule. Retail investors are guaranteed the best price that our securities markets have to offer regardless of the location of a trading transaction under our present regulatory system. By ensuring fair treatment, this best-price guarantee has significantly increased confidence in our securities markets. I also believe that this directive has served most investors generally well.

The Commission, however, has issued a proposal to permit participants in our capital markets to opt out under certain circumstances of this best-price guarantee. Some have suggested that this proposal could potentially produce unintended consequences like fragmenting our securities markets, decreasing liquidity, and limiting price discovery. Because such results could prove harmful for small investors, I will be monitoring this issue very closely in the weeks and months ahead.

A recent survey of older American investors also found that 86 percent of the respondents agreed that they should be alerted before the completion of a transaction in which the best available price is not the top priority. I would consequently like to learn from our witnesses how unsophisticated investors should be notified if their mutual fund manager, stockbroker, or pension fund adviser decides to opt out of the present best-price mandate. For example, it would be helpful to debate whether such opt-outs should be completed via a blanket disclosure or on a per-trade basis.

In sum, Mr. Chairman, we should continue to conduct vigorous oversight of our equities markets to determine whether or not the present regulatory structure is working as intended or to study how we could make it stronger. The observations of today's witnesses about these complex matters will further help me to discern how we can maintain the efficiency, effectiveness and competitiveness of our nation's capital markets into the foreseeable future.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 35 in the appendix.]

Chairman BAKER. I thank the gentleman.

Mr. Fossella, did you have an opening statement?

Mr. FOSSELLA. I will just submit mine for the record and look forward to hearing the testimony of these witnesses.

[The prepared statement of Hon. Vito Fossella can be found on page 30 in the appendix.]

Chairman BAKER. Without objection.

Ms. Velazquez, did you have an opening statement?

Ms. VELAZQUEZ. No, Mr. Chairman, but I will ask unanimous consent for my opening statement to be inserted into the record.

Chairman BAKER. Without objection, all Members's opening statements will be included in the record.

At this time, I would proceed to our distinguished panel of witnesses. First to give testimony today is Mr. Matthew Andresen, former president and chief executive officer of The Island ECN. Welcome, sir.

By way of customary practice, we would request if possible each statement be constrained to 5 minutes. Your entire official statement will be made part of the record. And make sure your button is on and pull the mike close. With that, take off.

STATEMENT OF MATTHEW ANDRESEN, FORMER PRESIDENT AND CEO, THE ISLAND ECN, INC.

Mr. ANDRESEN. Thank you, Chairman Baker, Ranking Member Kanjorski, members of the subcommittee. Thank you for holding this hearing and for inviting me to speak before you today.

We are at a crucial juncture in the evolving equity market structure of the United States. For decades, the electronic and traditional market structures continued their respective evolutions in relative isolation from each other. However, the furious pace of technological innovation, which I was privileged to be part of in my days at Island, has driven the electronic trading realm further and further away from the traditional human-driven markets of the NYSE-listed world.

The proponents of electronic markets believe that the results of this process have been purely positive. The champions of traditional markets believe that these rapid enhancements have sacrificed crucial elements of price discovery. I am certain, given the amount of legroom I have here today, that we will be hearing our fill today from both sides.

What is not in dispute, however, is that the rapid evolution of technology is forcing these two disparate worlds back together. The two competing market structures can no longer live in isolation from one another. This has manifested itself in several ways. First, the introduction of sophisticated technology tools to the brokerage and trading community has made it simple to deliver orders to either an electronic OTC market or to the NYSE through one common interface. This has facilitated the broad trend of sectorization whereby Wall Street firms reorganize their trading desks based not on where stocks might be listed, but rather based on what industry the companies themselves are in.

Secondly, the rise of automated and so-called "program" trading has blurred the distinction between listed and over-the-counter trading by often grouping orders together into lists of trades to be executed as a group. Third, the electronic markets have evolved into significant enterprises who view the big market cap stocks of the NYSE with jealous eyes. They know well the opportunity available. Despite their dominance of OTC trading, alternative trading systems and electronic exchanges account for only a tiny percentage of trading in NYSE-listed stocks.

It has long been my contention that this is due not only to the NYSE's significant liquidity advantage, but also the existence of the trade-through rule. This rule is an unfortunate relic of an age before fully electronic markets were in fact even contemplated. Obviously, they are commonplace today. But while the markets have evolved, the trade-through rule lives on in its original form. The essential issue with this rule is that it attempts to distill all of the value in a potential transaction down to one factor: advertised price. But advertised price is but one factor in determining the best execution for a customer. Factors such as time, implicit costs, fees, adverse selection and reliability can often make a much greater difference to a customer's quality of execution.

In my opinion, the debate over trade-through has been consistently misstated as one of speed versus price. To me, that is not wholly correct. The correct date is about true price versus advertised price, because in the stock market as in other transactions there are a myriad of factors that can lead to significant variance between the true and advertised price.

The aforementioned factors of time, certainty of execution, fees, adverse selection or reliability makes advertised prices only one small part of the execution story. We must have a regulatory structure that recognizes this face. I commend the committee for moving to address this issue.

Thank you, Mr. Chairman.

[The prepared statement of Matthew Andresen can be found on page 37 in the appendix.]

Chairman BAKER. Thank you very much, sir.

Our next witness is Mr. Larry Leibowitz, executive vice president, co-head of Equities Division, Schwab Soundview Capital Markets. Welcome, sir.

STATEMENT OF LARRY LEIBOWITZ, EXECUTIVE VICE PRESIDENT, CO-HEAD OF EQUITIES DIVISION, SCHWAB SOUNDVIEW CAPITAL MARKETS

Mr. LEIBOWITZ. Chairman Baker, Ranking Member Kanjorski, distinguished members of the committee, my name is Larry Leibowitz. I am executive vice president and co-CEO of Schwab Soundview Capital Markets, the institutional trading, research and retail execution arm of The Charles Schwab Corporation. Thank you for the opportunity to speak today on the vital market structure reforms proposed by the Securities and Exchange Commission.

Before I jump into my main statement, I would like to make a brief point. One thing that we on the panel here can all agree on is that these are relatively arcane topics. Talking about market linkages makes even my eyes glaze over so I can imagine yours. But in the end, they all impact the transparency and openness of the markets, and therefore contribute to investor confidence and the integrity and fairness in the largest and most successful system for capital formation in the world. Helping that system reflect the reality of today's information age is what this is all about.

Schwab Soundview Capital Markets, as the largest NASDAQ market-maker by volume, and Charles Schwab & Company, with its millions of retail customers, believe that the time is ripe for modernization of our national market system. We process millions of orders a day and those orders are directly impacted by the conflict between modern technology and human interaction when trading securities. These rules primarily serve to insulate outdated and inefficient manual markets from competition and actually harm, rather than protect, investors.

For too long, competition has been stifled in the market for NYSE-and Amex-listed securities. Given the very limited time available, I will focus my comments on the two main impediments: the trade-through rule and the market data charging system.

The trade-through rule purportedly protects investors from inferior prices, but has actually insulated the NYSE and its specialist system from competition and protected its privileged position. Given the NYSE's role in the creation of the original trade-through rule, the rule has worked as intended to protect its monopoly profits.

Being forced to route orders to manual markets for execution lowers efficiency and in some cases actually undermines a broker's duty of best execution. Moreover, investors attempting to cancel orders often find themselves in limbo waiting for an exchange response and discovering that their orders have been executed against their wishes. A better alternative is available. When securities are traded in an automated environment without a trade-through rule, as they are in NASDAQ today, investors obtain greater order protection, faster executions and better prices. Investors are protected by the broker-dealer's overriding legal obligation to provide best execution to customers.

In addition, when a market is efficient, you do not need a rule prohibiting trade-throughs. They simply do not happen. And you do not have to take my word for it. The Commission's own order-handling statistics, the so-called 11ACL-5 numbers, prove that automatic markets that are free of trade-through restrictions provide investors with better results, better prices, and faster executions.

The appropriate reform is obvious. Eliminate the ITS trade-through rule and allow competition to flourish as it does in the NASDAQ market. Short of full and outright repeal, Schwab proposes alternatively that the Commission first act to improve the interaction among markets trading listed securities. Then, after appropriate analysis of listed trading data, determine whether to eliminate the trade-through rule in its entirety.

Specifically we believe the Commission should take the following steps. Investors should be given the choice to ignore slow and inefficient market centers. Therefore, we urge the Commission to support a fast market/slow market exception to the trade-through rule. Such an exception will induce markets to implement automatic execution and automatic quote trading, thereby benefiting investors through the ensuing efficiency.

Second, the Commission should require specific disclosure of trade-throughs as part of 11AC 1-5 reporting, thereby allowing investors to determine the execution quality of their orders and allowing regulators to determine if the brokers are fulfilling best execution obligations.

Finally, Schwab believes that customers should be allowed to decide for themselves what constitutes best execution. Therefore, Schwab urges the Commission to amend the ITS plan to include an opt-out provision so that investors, rather than one-size-fits-all rules, can determine how to execute orders.

With regard to market data, Schwab believes that the current SEC proposal simply misses the real problem. Rather than treat the symptoms, the Commission should focus on reforming a monopoly-based system that wildly increases the cost to investors for trading information.

Investors have heard lots of stories about why market data is so expensive. We heard 2 weeks ago that it costs the NYSE $488 million per year to generate market data. That is hard to believe given that as the commission described in its reform proposal, last year the Plan Networks made $424 million in revenue and incurred only $38 million in expenses. That is a monopoly markup of 1,000 percent.

Further, NASDAQ, operator of one of the data networks, recently stated that it believes it can cut its monopoly data prices by 75 percent and still provide a sufficient return to shareholders. Clearly, there is excess market data money sloshing around the exchanges, which manifests itself in everything from tape shredding to market data rebates, to exorbitant pay packages for executives. This excess revenue is extracted from average investors who pay inflated charges to the exchanges to see their own limit orders displayed.

The government-created market data cartels should be asked to justify their cost. Until there is transparency in cost and governance, the market data cartels will never change and investors will continue to subsidize markets. Schwab believes that markets

should fund their own regulatory and operational functions directly and transparently themselves, rather than indirectly through opaque market data charges to investors.

Schwab has three recommendations. First, price information relating to the NBBO be based on its cost, thereby facilitating widespread availability. Second, simplify and standardize network accounting so that the expenses relating to market data consolidation are transparent, available to individual investors and independently audited. Finally, require public representation on network operating committees. A toothless advisory committee is a status quo proposal. Today, everyone acknowledges the need for independent members on the boards of public companies, mutual funds, and even SROs. Governance of market data should be no different.

In closing, Schwab commends this committee for exercising its oversight role and examining these important issues. To sum up, Schwab hopes the SEC repeals the trade-through rule, or at a minimum institutes meaningful reforms, thereby unleashing a wave of modernization in the listed market. Furthermore, we urge the Commission to reexamine its market data proposal to end monopoly profits and ensure that all investors have access, at a reasonable price, to the most basic trading information.

Thank you again for the opportunity to testify today. I look forward to any questions you may have.

[The prepared statement of Larry Leibowitz can be found on page 75 in the appendix.]

Chairman BAKER. Thank you, sir.

Our next witness is Mr. Daniel McCabe, chief executive officer, Bear Hunter Specialty Products. Welcome.

STATEMENT OF DANIEL MCCABE, CEO, BEAR HUNTER SPECIALTY PRODUCTS

Mr. MCCABE. Thank you. Good afternoon and thank you, Mr. Chairman, for the opportunity to testify in front of the committee.

A little bit of background first for the committee. I am the CEO of Bear Hunter Structured Products LLC. We are liquidity providers in derivative products such as options, futures and exchange-traded funds. Bear Hunter is a wholly owned subsidiary of Bear Wagner, which is one of the five major specialist firms on Wall Street. We represent more than 350 listed companies, including such household names as Pepsi, Aetna, Alcoa, Xerox and Kimberly-Clark to name a few. Bear Wagner is a member of the NYSE, Amex, CME, ISE, CBOT, and CBOE and actively trades in all venues.

Mr. Chairman, I am sincerely worried about the impact of the proposed changes, not only on the individual investor, but also on our listed companies and on the New York Stock Exchange itself. I am deeply concerned because the thrust of these new regulations is focused on speed only, and speed will ferment both price and temporal volatility in the market, scaring off individual investors, destroying confidence and over time driving down the market capitalization of our listed entities. Since the introduction of decimal pricing, the markets have already experienced a 126 percent growth in program trading, much to the detriment of the individual investor.

Allow me to elaborate. Excessive volatility serves no one but professional investors. Over the last 2 years, some 39 NASDAQ-listed companies have chosen to move to the New York Stock Exchange in order to reduce their volatility. They have, on average, experienced a 50 percent reduction in inter-day volatility. They made this choice to facilitate the raising of capital. After five years of market softness and financial scandals, is volatility really going to help lure investors back into the market, or are we creating a market dominated by professional program traders?

What is driving the focus on speed? Certainly not the majority of investors in this country. When AARP recently surveyed nearly 2,000 of its members, two-thirds of them said price is the top priority when engaging in a market transaction. The second consideration was brokerage fees. Speed barely registered in the survey.

Chris Hansen of AARP, representing that organization's 35 million voters, said, "The SEC needs to proceed carefully in proposing changes that could undermine the ability of individual investors to get the best price for the lowest transaction cost." I could not agree more.

Some of our competitors say everything should be done in nanoseconds, same-second executions should be the driving force in markets. I do not think we want the NYSE looking like an ECN, where stocks flicker excessively while attempting to discover price, nor do I understand why the markets with excessive volatility will be rewarded through the proposed changes in reg NMS.

In addition, I think the logical outcome of these proposed rules will be dramatic fragmentation and internalization of orders, where sophisticated investors opt out and the common person is left behind. The solution is not to develop a bifurcated market for insiders and small investors, but to instead link the markets together. Define a reasonable time frame, say five or six seconds, where orders must be executed or else face a penalty. Mandate that all parties compete on price.

Today, many people have the vision of the NYSE from a bygone era, with brokers wandering the floor, hand-writing orders on tiny scraps of paper. Over 85 percent of the orders are executed in less than 10 seconds. Specialists only provide liquidity roughly 15 percent of the time to smooth out short-term volatility, which helps stabilize the market for both investors and our listed companies. I think the real motive behind much of this debate has nothing to do with the individual consumer, but rather an attempt by failing business models to gain an advantage through regulations.

Here is a recent quote from Steve Pearlstein of The Washington Post: "The fact that these parties are trying to divert more trading away from the exchange raises suspicions that their lobbying campaign may have less to do with protecting the interests of the investing public than with gaining competitive advantage or taking over the market-making function themselves."

Again, let's look at NASDAQ. Five years ago, the exchange handled more than 90 percent of the market in their own stocks. Today, it is less than 20 percent. Currently, the NASDAQ and all of its electronic competitors move at the same speed. So why have they lost market share? Simply because of practices like payment

for order-flow or the sharing of tape revenue. Those practices must be disbanded for the mere health of the market.

Individual investors buy and sell based on price. When millions of investors get home tonight and check on their 401(k) programs, they will carefully watch the prices of their stocks and mutual funds. I cannot believe a single one of them will wonder whether their shares traded in 5 seconds or 8 seconds. Moreover, most will have no knowledge of which exchange traded their security or under what rules they were traded.

In conclusion, sir, the NYSE can move faster and yes, it should. But price and transparency are equally important principles this committee and the SEC must not abandon.

Thank you for your time and consideration.

[The prepared statement of Daniel McCabe can be found on page 78 in the appendix.]

Chairman BAKER. Thank you very much, sir.

Our next witness is Mr. John Giesea, president and chief executive officer, Security Traders Association. Welcome, sir.

STATEMENT OF JOHN GIESA, PRESIDENT AND CEO, SECURITY TRADERS ASSOCIATION, INC.

Mr. GIESEA. Good afternoon, Chairman Baker, Ranking Member Kanjorski and members of the committee. Thank you for the opportunity to testify this afternoon.

The Security Traders Association, or STA, is comprised of some 6,000 professionals engaged in the purchase, sale and trading of securities, representing individuals and institutions. In the context of today's topic, how will the investor fare, I would comment that I believe that investors have benefited greatly over recent years given improved market efficiencies and regulation. Proposed Regulation NMS, if properly implemented, will further these gains through improved linkages, liquidity and competition.

The STA is currently in the process of completing its formal comment on proposed Regulation NMS. This has involved input from more than 60 professional traders representing both the buy side and the sell side. I will highlight the major points of Regulation NMS where STA has preliminarily reached consensus with regard to the trade-through. The STA believes that a fully linked market with automatic execution capability will substantially diminish the need for a trade-through rule.

One way to address the trade-through proposal would be to execute it in a phased approach and implement it only after a comment period for review. Phase one, define automated and a non-automated markets; phase two, oversee the creation of linkages to ensure a high degree of connectivity and access; phase three, reexamine the need for a trade-through rule as such a rule may be impossible to enforce as well as unnecessary given the competitive forces driving best execution standards. The result of this phase-in approach would be a major step towards the envisioned national market system and beneficial for market participants and investors.

The current proposal would extend the trade-through rule to the NASDAQ market. We question why when there have not been problems regarding price protection the rule should be imposed

upon the NASDAQ stock market. It would be incorrect to impose this rule at the onset. Although there may be some practical and other drawbacks to an opt-out, we would support an opt-out exception on an interim basis for the purpose of driving greater automation in or access to markets. This would provide incentive for change. However, if automatic execution and economic access to quotes were achieved, an opt-out provision would become unnecessary.

A key determination is the definition of an automated market. STA believes that a market must provide for an automatic execution, coupled with an immediate refresh capability. With regard to access fees in lock and cross markets, the Commission has correctly identified access fees as a critical component of any discussion regarding best execution. The SEC's proposal to cap fees at $0.001 per share is a very positive step towards reducing the current problems in the marketplace. However, we believe the preferred action is complete elimination of access fees, which would also eliminate the economic, or at least one of the economic incentives which cause lock and cross markets. The SEC's proposal appropriately calls upon markets to create and enforce rules eliminating lock and cross markets which STA strongly supports.

With regard to sub-penny quotes, sub-penny quotations create a number of problems, and we are against the introduction of decimals as originally proposed, and we strongly support the Commission's recommendation that sub-penny quotations be eliminated. We do distinguish between quotation and transaction as there are some common needs to have a transaction that creates a sub-penny, but quotations should be limited to two decimals.

With regard to market data, the STA is not in a position to comment on the precise formula to be used for the distribution of market data revenues. We are, however, supportive of the market data allocation proposals that lead to rewarding quality quotes at the same time eliminating the practices only designed to gain the revenue stream.

With regard to liquidity providers, I would also note the importance of liquidity providers, namely specialists and market-makers, to the capital formation and the efficient functioning of the markets. The trend in rulemaking has been to encourage the matching of buyers and sellers without an intermediary. Highly liquid stocks do not under normal circumstances require a liquidity provider to facilitate the execution of trades. However, the need for liquidity providers becomes important in stress situation, be they stock-specific or general market conditions.

In conclusion, I thank the members of the subcommittee for your continued interest in ensuring that U.S. markets are efficient and liquid. Such characteristics are important to a robust capital formation process, benefit the U.S. economy, and ultimately benefit all investors.

The STA views the national market system principles established in the Securities Acts Amendments of 1975, namely the maintenance of efficient, competitive and fair markets, as both a measure and a goal. The SEC proposed Regulation NMS is a step toward the goal of a true national market system.

Thank you.

[The prepared statement of John Giesea can be found on page 70 in the appendix.]

Chairman BAKER. Thank you very much, sir.

Our next witness is Dr. Benn Steil, the Andre Meyer Senior Fellow in International Economics, Council on Foreign Relations. Welcome.

STATEMENT OF BENN STEIL, ANDRE MAYER SENIOR FELLOW IN INTERNATIONAL ECONOMICS, COUNCIL ON FOREIGN RELATIONS

Mr. STEIL. Thank you, Mr. Chairman, members of the committee.

Although the SEC's proposed Regulation NMS covers a wide range of important issues related to market linkages, access fees and market data, I will confine my brief prepared remarks to the specific matter of the trade-through rule, changes in which have the greatest potential to improve the ability of our securities markets to service investors.

Although the idea of having a simple market-wide rule to ensure that investors always have access to the best price is an attractive one, in practice the trade-through rule has operated to force investor orders down to the floor of the New York Stock Exchange irrespective of investors's wishes. The rule therefore operates to discourage free and open competition among marketplaces and market structures, the type of free and open competition which has in Europe produced a new global standard for best practice both in trading technology and exchange governance.

The trade-through rule should therefore be eliminated, as it serves neither to protect investors nor to encourage vital innovation in our marketplace. Those who support the maintenance of some form of trade-through rule, most notably the New York Stock Exchange, have raised five main arguments in its defense. The most effective way to illustrate why the rule is undesirable is to address each of these directly.

First argument: Why should speed be more important than price? According to this view, eloquently presented by Mr. McCabe, the whole debate is about whether traders should be allowed to sacrifice best price in pursuit of speed. But the notion that investors would ever sacrifice price for speed is nonsensical. In the marketplace, it is always about price. It is about the price for the number of shares the trader wants to trade, not just the 100 shares advertised on the floor of the New York Stock Exchange, and it is about the price that is really there when the trader wants to trade. Statistics from competing marketplaces about fill rates, response times and the like make very nice input into a trader's decision, but they are not substitutes for a decision.

Argument two: But the rule is necessary to protect market orders. The normal fiduciary principle says that the agent must act in the customer's interest, but the trade-through rule says that the agent must ignore the customer's interest. In other words, to eliminate any possibility that a broker may abuse his discretion, regulators should forbid not only his discretion, but his customer's discretion. This cannot be sensible, Mr. Chairman.

To illustrate, an investor may wish to buy 10,000 shares at $20 a share done at a keystroke on market X. The trade-through rule,

however, would oblige that investor instead to buy only 100 shares at $19.99 at the New York Stock Exchange and then submit to a floor auction there, so that exchange members on the floor may profit from knowledge of his desire to buy many more shares. Tellingly, the same people who insist that brokers will abuse discretion or that their customers should not be entitled to it, will defend to the death the right of specialists to use discretion. This view, curiously, is entirely unburdened by knowledge of the $241.8 million in fines paid by five of the seven NYSE specialist firms for improper discretionary trading.

Argument three: But the rule is necessary to protect limit orders. According to this argument, it is not the market orders that have to be protected, but rather 100-share limit orders. But this is a strange principle for the NYSE to defend, given that the floor could not even exist were it not for the ability of specialists and floor brokers to trade in front of limit orders. Indeed, the most frequent complaint of institutional investors about trading on the floor is precisely the fact that limit orders are revealed to the crowd, who are then allowed to use that information to trade in front of them. In a marketplace, Mr. Chairman, it takes two to trade. The fellow who puts down a limit order in market X has no moral standing over the gal who sees a better package deal in market Y. Appeals to fairness favor neither one over the other.

Fourth argument: But if limit orders are traded through, no one will place them. If limit orders are traded through on market X, they just will not be placed on market X. They will move to market Y, where they will not get traded through.

Fifth and final argument: But a fair compromise is to have a trade-through rule among fast markets. The NYSE has stated repeatedly that in the fast exchange of the future, there must be a role for the floor action. To be clear, this means that the NYSE will only be fast for as few shares as the SEC will let them get away with. So to go back to the example of an investor wanting to buy 10,000 shares available on market X at $20 a share, if the NYSE is designated a fast market it means only that the NYSE might sell him a fast few hundred shares at $19.99, but then just like old times, Mr. Chairman, the exchange will force him into a floor auction.

More fundamentally, do we really want the government to be in the business of determining which markets are fast enough for all investors, now and in the future, and doling out protection from competition on that basis? My judgment is that we do not.

To conclude, I do not believe that any of these arguments for a trade-through rule are compelling. Moreover, the rule is not even enforced at present against its leading supporter and only systematic violator, the New York Stock Exchange, which trades through other markets hundreds, even thousands of times every day. Since the SEC is silent on the question of how the rule will actually be enforced in the future, it must be assumed that if perpetuated it will continue to operate solely to force investors to trade on the New York Stock Exchange, even if they desire to do otherwise.

The SEC should, of course, be concerned to see that intermediaries do not abuse their discretion in handling investor orders, but given that the focus of recent SEC disciplinary action has been

improper discretionary trading by specialists, it cannot be in the interest of investors to oblige them to trade with specialists if they do not wish to do so. After all, the SEC emphasizes in its proposal that a trade-through rule, and I am quoting, “in no way alters or lessens a broker-dealer’s duty to achieve best execution for its customers’s orders.” If this is truly the case, Mr. Chairman, then a trade-through rule is neither necessary nor desirable.

I thank you for the opportunity to testify this afternoon and I look forward to assisting your deliberations in any way possible.

[The prepared statement of Benn Steil can be found on page 83 in the appendix.]

Chairman BAKER. Thank you, sir.

Our next witness is Dr. Daniel G. Weaver, visiting associate professor of finance, Department of Finance, Rutgers School of Business. Welcome, sir.

STATEMENT OF DANIEL G. WEAVER, VISITING ASSOCIATE PROFESSOR OF FINANCE, DEPARTMENT OF FINANCE, RUTGERS SCHOOL OF BUSINESS

Mr. WEAVER. Thank you.

Mr. Chairman, let me state unequivocally that I am against repeal of the trade-through rule. If the rule is repealed, it will further fragment our markets and hurt investors. It will be a large step backward in the modernization of U.S. markets, effectively taking us back to pre-Manning rule days. The history of the Manning rule has reverse parallels to the proposed repeal of the trade-through rule. Prior to Manning I, which was enacted in 1994, if an individual investor sued their broker, NASDAQ dealers could simply ignore customer limit orders. Customers learned that limit orders were not executed and did not submit them.

Manning I prevented NASDAQ dealers from trading through customer limit orders at better prices, much like current trade-through rules do today. However, after the passage of Manning I, NASDAQ dealers could still trade ahead of their customer’s limit orders at the same price. There was no public order priority rule.

Manning II enacted about a year later gave public limit orders priority, but only within a dealer firm. In other words, a customer submitting a limit order to dealer X could still see trades occurring at other dealers at the same price or worse than the customers’s limit order. Thus, Manning II still discouraged public limit order submission. It took the order handling rules enacted by the SEC in early 1997 to unleash the potential of public limit orders in the NASDAQ market. After the OHR, spreads dropped dramatically. ECNs, which despite customer limit orders, grew in market share from about 10 percent to 80 percent today. ECNs allow public limit orders to compete with NASDAQ market-maker quotes.

The lesson is clear. If limit orders stand a chance of execution, they will be submitted and can then become an important source of liquidity for markets. We need liquidity in our markets. Limit orders are shock absorbers for liquidity events. Without limit orders to absorb trades from liquidity demanders, large orders will increasingly push prices away from current prices. While it may be argued that price impact is a fact of life for large institutional traders, I am more concerned about the small trader that submits an

order at the same direction, but just behind the large order. The small order will execute at an inferior price before sufficient liquidity can be sent back to the market by traders.

Repeal of the trade-through rule, then, would take us back to pre-Manning rule days. It will discourage limit order submission and in turn increase volatility in affected stocks. This will result in a higher effective execution cost for the average investors. A few large players will benefit, but it will be at the expense of the majority of long-term investors. It has been shown time and time again that investors factor execution costs into the required cost of supplying funds to firms. Therefore, higher execution costs will translate into higher costs of capital for firms and stock prices will fall. This will make it more difficult to raise capital and hence provide a drag on the economy.

As an example, on April 11 of 1990, the Toronto Stock Exchange, TSX, enacted rules that resulted in the effective execution costs increasing by about .025 percentage points. Within a week, prices declined by over 6 percent and stayed there. This impact on prices will happen if the trade-through rule is repealed. It will set us back 10 years and put us dead last in the modernization of markets among industrial nations.

Other nations have seen the value of routing orders according to price. The TSX affected rules that require brokers receiving market orders of 5,000 shares or less to either improve on price or send the order to the TSX for execution against public limit orders. Following that action, affected stocks experienced an immediate increase in depth and reduction in spread. Evidence from U.S. markets finds the same result. When Merrill Lynch decided to stop routing their orders to regional stock exchanges and instead routed them directly to the New York Stock Exchange, spreads narrowed and customers obtained better executions. Recently, the EU has passed the investment services directive II, which is similar to TSX concentrates on rules and requires orders that occur off exchanges to be improved-on price; not worse price, not same price, better price.

The above are examples of the adage that liquidity begets liquidity. In other words, limit order traders will submit limit orders where market orders are. It is similar to the fact that the more traffic exists on a highway, the more gas stations will exist. If the traffic goes away, so will the gas stations. Similarly, if market orders get routed away from the venue with the best price, limit orders will leave that venue as well. Going back to the gas station example, it does not matter how cheap your gas is. You will not sell much at the back of a dead-end street.

If markets want to truly compete, they should do so on price, which is the current structure. However, the entire notion of markets competing is problematic. True competition is between natural buyers and sellers. I doubt if any member of the public ever received a call from the Chicago Stock Exchange asking them to send their orders in NYSE-listed stocks to them, but their brokers did.

Allowing orders to be routed for reasons other than best price will increase the incidence of preferencing, again taking us a big step backward in efforts to modernize our market. I am generally against allowing traders to give blanket opt-outs of the best price

rule. Most investors do not know their bid from their ask, and I am afraid will quickly agree to allow their brokers to opt out of their accounts. This opens the floodgates for abuse by brokers, undoing years of regulatory mandated improvements in our markets. There may be something to be said for allowing some large traders to make an informed decision to opt out on a trade-by-trade basis. However, I would suggest that this can be accomplished through the changes to the rule for block trades.

Therefore, I really do not see a need for an opt-out ability. If enough investors opt out, then market orders can be routed away from current venues and executed at inferior prices. This will discourage traders from providing liquidity, leaving more volatility in the markets, higher execution costs, and higher costs of capital for U.S. firms. Repealing the trade-through rule in listed markets will result in fragmentation for listed stocks similar to that on NASDAQ. The fragmentation of NASDAQ has led to an increased usage of order routers to find liquidity. The creation and sale of order routers is perhaps the biggest growth segment of the securities industry today.

Companies like ITG do a big business selling trading firms their order routing services. Now, these order routing firms are not charitable organizations, but for-profit. Therefore, it costs money to find liquidity in the OTC market today. This further adds to execution costs, therefore increasing the fragmentation of markets by allowing opt-outs to the trade-through rule and will result in higher execution costs because of the increased cost of finding liquidity.

Thank you for inviting me today, Mr. Chairman.

[The prepared statement of Daniel G. Weaver can be found on page 96 in the appendix.]

Chairman BAKER. Thank you, sir.

Our next witness is Mr. Kim Bang, president and chief executive officer, Bloomberg Tradebook. Welcome.

STATEMENT OF KIM BANG, PRESIDENT AND CEO, BLOOMBERG TRADEBOOK LLC

Mr. BANG. Thank you, Mr. Chairman and members of the subcommittee. My name is Kim Bang and I am pleased to testify on behalf of Bloomberg Tradebook.

In early market structure hearings, Chairman Oxley asked, why does the New York Stock Exchange control 80 percent of the trading volume of its listed companies, when NASDAQ controls only about 20 percent of the volume of its listed companies? The answer is simple. There has been and continues to be numerous impediments to electronic competitors. The NASDAQ price-fixing scandal of the mid-1990s resulted in sanctions by the SEC and the Department of Justice and decisions on market structure intended to enhance transparency and competition in the NASDAQ market.

Specifically, the SEC's 1996 issuance of the order-handling rules permitted electronic communication networks, ECNs, to flourish, benefiting investors and enhancing the quality of the market. NASDAQ spreads narrowed by nearly 30 percent in the first year following the adoption of the order-handling rules. These and subsequent reductions in transactional costs constitute significant sav-

ings that are now available for investments that fuel business expansion and job creation.

The question confronting the SEC and Congress is whether equity markets can be reformed to bring the same benefits to the New York Stock Exchange investor as they have to the NASDAQ investor. The trade-through rule is the foremost impediment to that opportunity.

Currently, the inter-market trading system trade-through rule protects inefficient markets, while depriving investors of the choice of anonymity, speed or liquidity by mandating instead that investors pursue the advertised theoretical best price, instead of the best available firm price. Ending the trade-through rule would allow investors to choose the markets in which they wish to trade, which would in turn promote competition and benefit investors. The results would be greater transparency, greater efficiency, greater liquidity and less intermediation in the national market system, which are precisely the goals of the Securities Acts Amendment of 1975.

Rather than introducing a complex new trade-through rule that would be expensive to implement and unlikely to be enforced, we suggest launching a pilot program similar to the ETF de minimus exemption for a cross-section of listed stocks. With no trade-through rule restriction, the Commission could then monitor and measure the results of these three competitive forces.

I cite in my testimony a study appraising a real-world experience in which market quality did not diminish, but actually improved in the ETFs with the relaxation of the trade-through rule. This is no surprise, as the second largest market in the world, namely NASDAQ, functions very effectively without a trade-through rule.

As to market data, the Financial Services Committee has long held that market data is the oxygen of the markets. Ensuring that market data is available in a fashion where it is both affordable to retail investors and where market participants have the widest possible latitude to add value to that data are high priorities. In its 1999 concept release on market data, the Commission noted that market data should be for the benefit of the investing public. Indeed, market data originates with specialist market-makers, broker-dealers and investors. The exchanges and the NASDAQ marketplace are not the sources of market data, but rather the facilities through which market data are collected and disseminated.

In that 1999 release, the SEC proposed a cost-based limit to market data revenues. We believe the SEC was closer to the mark in 1999 when it proposed making market data revenues cost-based, rather than in its Regulation NMS proposal which proposes a new formula for dispensing market data revenue without addressing the underlying question of how effectively to regulate this public utility function.

In addition to questions regarding who owns market data and who shares in the revenue and the size of the data fees, we believe the Commission ought also to revisit how much market data should be made available to investors. Here, decimalization has been the watershed event. Going to decimal trading has been a boon for sure to retail investors. It has been accompanied, however, by a drastically diminished depth of displayed and accessible liquidity. With

100 price points to the dollar, instead of eight or sixteen, the informational value and available liquidity at the best bid and offer have declined substantially. In response to decimalization, the Commission should restore lost transparency and liquidity by mandating greater real-time disclosure by market centers of liquidity, at least five cents above and below the best prices.

I would like to touch briefly on one other aspect of Regulation NMS, namely access fees. Bloomberg has long believed that access fees should be abolished for all securities in all markets. While we applaud the SEC's efforts to reduce access fees, we are concerned that the complexities inherent in curtailing these fees without eliminating them are likely to create an uneven playing field.

In conclusion, this committee has been at the forefront of the market structure debate and I appreciate the opportunity to discuss how these seemingly abstract issues have a real concrete affect on investors. Regulation NMS is a bold step to bring our markets into the 21st century. However, we believe there is a risk that Regulation NMS may reshuffle, rather than eliminate current impediments to market efficiency. Elimination of the trade-through rule, elimination of access fees, to restore lost transparency lost to decimalization, and to control the cost of market data would help promote a 21st century equity market that best serves investors.

Thank you very much.

[The prepared statement of Kim Bang can be found on page 46 in the appendix.]

Chairman BAKER. Thank you, sir.

Our next witness is Mr. Peter J. Wallison, resident fellow, American Enterprise Institute. Welcome.

STATEMENT OF PETER J. WALLISON, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. WALLISON. Thank you very much, Mr. Chairman. I am pleased to have this opportunity to offer my views on the SEC's proposed Regulation NMS.

Regulation NMS is a complex proposal with elements that address different aspects of the national market system. I will only discuss the basic question of market structure, which is implicated by the regulation's proposed changes in the applicability of the trade-through rule.

The U.S. securities market today consists of two entirely different structures, a centralized market for the trading of New York Stock Exchange-listed securities; and a set of competing market centers for the trading of NASDAQ securities. One of these models and only one is likely to be best for investors, and hence the best market structure. But Regulation NMS does not help us decide which it is. In fact, by allowing some investors and markets to trade-through prices on the New York Stock Exchange and by attempting to impose the trade-through rule on the trading of NASDAQ securities, Regulation NMS further confuses the issues.

The fundamental question of market structure is whether investors are better off when securities trading is centralized in a single dominant market, or when it is spread among a number of competing market centers. If the SEC is interested in reforming securi-

ties market structure, it must address this question. Regulation NMS does not do so.

Accordingly, I believe the regulation should be withdrawn until the SEC has done sufficient study and analysis of market structure to make an appropriate recommendation.

There are two basic models for organizing a securities trading system. In the first, trading in specific securities is centralized so that, to the maximum extent possible, all orders to buy and sell meet each other in a central market. In economic theory, this produces the greatest degree of liquidity and thus the best prices and narrowest spreads.

This model has two potential large-scale deficiencies, however. It forces all trading into a single mode—one size fits all—and thus will not meet the trading needs of some investors; and it does not create incentives for innovation or encourage accommodation to the changing needs of investors. The second model is a decentralized structure that contemplates competing market centers. Any security can be traded in any market. The advantages of this structure are that it can potentially meet the trading requirements of the greatest number of investors, and because the markets are in competition with one another, it provides adequate incentives for innovation and change.

The disadvantage of this structure is that is breaks up liquidity and thus could potentially interfere with price discovery. It also could result in investors getting different prices for the same security, executed at the same time, which some regard as unfair. The reason for the difference between competitive conditions in the two markets is probably the trade-through rule, which is applicable to New York Stock Exchange-listed securities, but not, for historical reasons, to those listed on NASDAQ.

The trade-through rule requires that customer orders to buy or sell NYSE securities be forwarded to the market center where the best price for those securities has been posted, usually the NYSE. The purpose of the rule in conformity with the SEC's longstanding policy, is to increase the chances that buyers and sellers of a security will get the best price available in the market at the time they want to trade, even if the security is traded in different markets.

It appears that if the trade-through rule were eliminated entirely, much of the trading in New York Stock Exchange securities would move to the automated markets such as the ECNs. This seems likely because in the NASDAQ market, where the trade-through rule was not applicable, ECNs have been able to capture much of the trading from NASDAQ market-makers themselves. There are good reasons for this, especially for institutional investors, detailed in my prepared testimony. From the perspective of institutional investors, electronic markets may offer the best available prices because they allow trading in large amounts with relatively low market impact.

Thus, one way to state the question before the SEC is whether the trade-through rule should remain applicable to trading in New York Stock Exchange securities. If the SEC believes that overall, taking into account its advantages and disadvantages, the centralized trading on the New York Stock Exchange is superior to the decentralized structure of the NASDAQ market, then it should retain

the trade-through rule. On the other hand if it believes that the decentralized structure of the NASDAQ market overall is superior, then it should eliminate the trade-through rule entirely so that all market centers could trade all securities.

In Regulation NMS, the SEC has done neither and both. It is proposing to eliminate the trade-through rule in some circumstances, and to impose it in others where it does not currently apply. This indicates to me that the SEC is unwilling or unable to grapple with the central question of market structure—whether to favor a centralized trading model like the New York Stock Exchange, or a market that consists of competing trading venues.

Without deciding this question, there is no point in adopting another regulation. Instead, I would suggest that the SEC withdraw the regulation and do the necessary work to decide how the securities market should be structured in the future.

That is my testimony, Mr. Chairman.

[The prepared statement of Peter J. Wallison can be found on page 88 in the appendix.]

Chairman BAKER. Thank you, Mr. Wallison.

Mr. McCabe, much of your testimony is based on the principle that execution at the best price should be the stalwart principle from which we should not retreat. To that extent, I think most would agree that coming down on the side of the consumer is always a good choice. But can you represent to me that today all trades are executed at the best price available on the New York Exchange at the time of execution?

Mr. MCCABE. Sir, first off I have to say that I do not represent the New York Stock Exchange. I work for a subsidiary broker-dealer. On the New York Stock Exchange, we have rules that say that we must attempt always to get the best price for a customer. If for any reason we fail at that, there are methods for people to redress that. But I would say that the vast majority of the time, yes, they do get the best price.

Chairman BAKER. I do not know if there is someone who chooses to offer the counter view. I have received information from other exchange representatives who allege as to the frequency of thousands of times a week that there are executions that occur on the New York exchange, not by necessarily adverse intent, but due to technological limitation that the executions do not occur at the best price. That is, in fact, what is driving my review of the matter is that I believe the current system is faulty in that regard, and that you do not necessarily attain best price.

But let's move past that. Assume for the moment you are correct and some investor has reason to want to have some other principle guiding his investment decision. Dr. Weaver, you indicated that most investors do not know bid from ask, but let's assume for a moment we have one who has gotten pointed out in the right direction. If he has some other strategic reason to want to execute, why should not that consumer be given his choice as opposed to the mandatory rule?

Mr. WEAVER. Are we only going to worry about that consumer? Or are we going to worry about the market as a whole? If orders get routed away from a market center, then people realize that their limit orders are not going to get executed and they are not

going to submit them. Too long in this country, the SEC has focused on coming up with the smallest spread, but we need to worry about providing liquidity to the marketplace. Liquidity is a shock absorber. You need to have them there. You do not want to have your shock absorbers at home in the garage right before you get into a pothole.

Chairman BAKER. That assumes that once the order would not be placed, that the demise of the western civilization follows because the liquidity disappears, as opposed to going to perhaps another exchange. You are saying it parks on the sideline and forever disappears from the economic system? How do we get to that conclusion?

Mr. WEAVER. No, sir, I am not saying that at all. First of all, you are assuming there is another exchange for them to go to. What if it is a market-maker who is operating proprietarily and does not accept customer limit orders to compete for the other customer's order? There is no way for that limit order to get there.

Chairman BAKER. I am not arguing that the role of the specialist is not needed.

Mr. WEAVER. No, I am not talking about the role of the specialist either, sir.

Chairman BAKER. I am saying that where there is a liquid market for a publicly traded stock, where someone has an alternative reason for exercising other than best price, which by the way we do not get in the New York Exchange anyway, why don't we let the customer choose? We can put a big bumper sticker, the surgeon general says this could be hazardous to your health, whatever we want, but let people make choices. I think that is more the inherent in the free market system than something that says you must do this in order to participate.

Mr. MCCABE. Mr. Chairman, if I may address that just quickly.

Chairman BAKER. Sure.

Mr. MCCABE. The point you have just made is that you do not get the best price on the New York Stock Exchange. I have not seen anyone publish data that says that, other than some of these competitors sitting around here, and quite frankly I question some of that data. The most recent 11(a)(c)1-5 report shows that actually the fill rate on the New York Stock Exchange for marketable limit orders is 72.3 percent. The highest competitor below that for market orders is the NASDAQ. They are at 60 percent, sir. All the other RCNs go down from there.

Chairman BAKER. So it would be, not easy, it takes some work for folks to determine it, but based on that we will get the SEC working to find out.

Let me ask another question though. The Philadelphia model has competitive specialists, as opposed to the New York Exchange which has the dedicated specialist. Is there something wrong with the Philadelphia model that would not make sense? If we are going to have limited competition, can't we at least have it among the specialists on the trading floor?

Mr. MCCABE. I think it is always good to know if you have a problem you have to address, so I do think it is important that you have one person in control. I do agree that there are different market structures and some of them work rather well. I think that the

market structure on the Chicago Mercantile Exchange with comparative market-makers and also the new futures that they are rolling out have what they call DPMs, that market structure even in the futures is a very interesting market structure. It may actually sometime in the future be what the New York Stock Exchange evolves into.

Chairman BAKER. But you do not necessarily see the Philadelphia model as a flawed model?

Mr. MCCABE. I do not quite frankly know the percentages of trades that are going on there, nor do I know enough about that model to speak appropriately on it.

Chairman BAKER. We will just say possibly could be, but we need to have further examination.

My time has expired, and I know we are going to have to break for votes here shortly. I want to make sure other members get their chance to make their statements.

Mr. Hinojosa is next, then you, Mr. Crowley.

Mr. HINOJOSA. Thank you, Chairman Baker. I want to thank you for holding an additional hearing to review the structure of our capital markets, in particular the SEC's proposed national market system regulation and how investors would fare under that proposal.

My first question is for Dan Weaver. Dr. Weaver, what impact would the SEC's proposed national market system rule have on limit orders?

Mr. WEAVER. Which part of the NMS are you referring to? I am sorry. The trade-through rule?

Mr. HINOJOSA. Yes, the trade-through.

Mr. WEAVER. It encourages limit order submission. Right now, there is a trade-through rule on NASDAQ. It is on a firm-by-firm basis. It does not apply across the market. The SEC is suggesting that we should apply it across the market. I strongly support that. It will encourage limit order submission. The reason ECNs were started on NASDAQ was because limit orders were being ignored by the market-makers, and anything that we can have that will give limit orders some priority in the marketplace will help our markets.

Mr. HINOJOSA. Dr. Weaver, how will all investors, not just the sophisticated ones, be notified that their mutual fund manager, their broker or pension fund manager, is opting out of the trade-through rule?

Mr. WEAVER. I do not know how they would be notified because I am against them opting out, really.

Mr. HINOJOSA. Who can tell me how that notification would occur? Anybody on the panel? Yes, sir.

Mr. LEIBOWITZ. It is my understanding that the intention would not be for mutual fund managers to notify specific investors. Remember that mutual fund managers first of all have a great degree of discretion in execution anyway. They also have a fiduciary responsibility to the client, and it is their job as a sophisticated investor themselves to get the best prices for their client. That is part of what they do as a money manager.

Mr. MCCABE. If I may also, today currently I believe Charles Schwab, working the best execution for their customers, internal-

izes 95 percent of the order flow in NASDAQ securities. I would question whether or not all those customers are guaranteed best price.

Mr. HINOJOSA. Okay.

Mr. LEIBOWITZ. I would like to respond to that, if you do not mind.

Mr. HINOJOSA. Certainly, go ahead.

Mr. LEIBOWITZ. I can tell you that it is our best execution obligation and that we would be examined and fined if we did not provide it. If you look at our best execution stats, they are actually superior to the New York Stock Exchange in almost every instance, and you not only get better prices, but it is at a faster speed.

Mr. MCCABE. I agree with Larry you can do things quickly, but he did not say that they guarantee best price.

Mr. LEIBOWITZ. No. In fact, I am saying we do guarantee them the best price.

Mr. HINOJOSA. The next question would be for Dan McCabe. Mr. McCabe, what is the fundamental difference between the electronic commercial networks and the exchanges?

Mr. MCCABE. Quite frankly, sir, the ECNs are just what they state. They are electronic communication networks. They match orders that happen to be in the system. If there are no buyers or no sellers on one side, a trade cannot occur. There is nobody in any of these platforms that is mandated or required to provide liquidity. On the exchanges, whether it be on Philadelphia or the New York or out in Chicago, there are people who are given the responsibility of making fair and orderly markets. That is the difference between the exchanges.

Mr. HINOJOSA. This last question is for Dan Weaver and Daniel McCabe. What would happen if in the end, the SEC were to withdraw the proposed NMS rule?

Mr. MCCABE. If I may, I think the New York Stock Exchange quite frankly has changed. I think the proposed rules have caused people to address things that needed to be addressed for some time. I am very happy to see that. I think those changes will continue because of people like Mr. Thain coming into the exchange and bringing the appropriate people with him.

If it is withdrawn, I think that there are certain portions that we are still going to have problems with, most notably not the trade-through rule, but the payment-for-order flow and the sharing of tape revenue that really needs to be addressed in these markets.

Mr. WEAVER. Let me follow up on that, if I may. I think if they withdrew the proposal, it would keep us near the back of the pack in the modernization of markets. In particular, the portion of the NMS that refers to decimalization and attempting to ban subpenny quoting would continue to further fragment our markets and discourage limit order submission. I am afraid that a down market of the ilk of 1987 could be more disastrous because there is a lot less liquidity in the marketplace than their used to be.

Mr. HINOJOSA. Chairman Baker, I look forward to hearing investors's opinions of the SEC's proposal in the near future. I found you always to be inclusive, so we have no doubt that you will allow us to hear from investors before this is over, before the end of this session. Finally, I ask unanimous consent that my opening

remarks be made a part of the record because I was on the floor and I could not be here for the beginning.

[The prepared statement of Hon. Rubén Hinojosa can be found on page 33 in the appendix.]

Chairman BAKER. Mr. Hinojosa, your statement will be incorporated as part of the record, and I assure you will hear a great deal more about this subject.

Mr. Crowley?

Mr. CROWLEY. Thank you, Mr. Chairman. I, too, want to thank you for holding these series of hearings on market restructuring reform.

I, too, have an opening statement that I would also submit for the record.

[The prepared statement of Hon. Joseph Crowley can be found on page 28 in the appendix.]

Chairman BAKER. All members's statements will be made part of the official record.

Mr. CROWLEY. Thank you, Mr. Chairman.

I would first of all want to, in the sense of truth in advertising, follow up on what Mr. Hinojosa just spoke about, the hearing is entitled "The SEC Proposal on Market Structure." How will investors fare? I am struggling as best I can, and I can certainly make arguments, and this is not disparaging of the panelists before us, but I am trying to determine who here really represents the interests of the investor. The investor today has taken on many, many new forms, and especially mom-and-pops who in the past were not necessarily in the market, but who are in there today.

So I would also like to include for the record someone who does represent, at least in some capacity, the investors. That is the public advocate for the city of New York, Betsy Gotbaum, who in a letter representing more than eight million New Yorkers, many of whom are mom-and-pops, as well as others who are invested in the markets today, who is offering her opinion in opposition to any change in the trade-through rule. I would offer that for the record.

Chairman BAKER. Without objection.

[The following information can be found on page 102 in the appendix.]

Mr. CROWLEY. Just one more point, again truth in advertising, and again, Mr. Steil, this is toward you, I note that on the witness list it says that you are a Andre Meyer Senior Fellow in International Economics at the Council for Foreign Relations. Are you representing the Foreign Relations Council here today?

Mr. STEIL. No one can represent the Council on Foreign Relations in terms of representing its views. The Council on Foreign Relations has no institutional position on any subject matter whatsoever. Even the president of the Council on Foreign Relations cannot state a view on policy of the Council on Foreign Relations.

Mr. CROWLEY. I appreciate that. You are probably right. But are you not also the director of the London-based stock exchange Virt-x, an ECN that would clearly benefit if the trade-through were eliminated or at least provided with an opt-out provision?

Mr. STEIL. In fact, I was discussing this matter with Dan Weaver before we started the testimony here today. Virt-x is a stock exchange, not an ECN. It trades primarily Swiss SMI stocks. The big-

gest beneficiary in the world that I know of, of a trade-through rule would be Virt-x, the reason being that Virt-x, being a new competitor in the pan-European trading market was trying to generate liquidity in non-Swiss stocks when it did not have it in the first place.

In its first year of operation, it was quite successful in achieving very narrow spreads on a limited number of high-volume European stocks. For example on Deutsche TeleKom, on many months Virt-x had a narrower inside spread on most days than the home market Deutsche Borse, yet Virt-x got very little order flow in Deutsche Telekom. So Virt-x would be an enormous beneficiary of a European trade-through rule.

Mr. CROWLEY. I am not so sure where your conflict comes in. It is either with Virt-x, or for the panel today in terms of your discussion.

Mr. STEIL. You are making my argument for me. I am not here to represent Virt-x in any capacity whatsoever. I am a non-executive director of Virt-x. I do not come here speaking for Virt-x in any capacity whatsoever. I am speaking here today solely for myself.

Mr. CROWLEY. Fair enough. Let me just move on.

A number of years ago, a number of firms represented here today were making the argument that the New York Stock Exchange was a dinosaur, that it was outmoded, that it was not performing in essence in a fair way towards its investors in providing fast enough or expedited movement. They were making the argument that the lack of speed was the downfall of the stock exchange. I, for one, and many in the committee have made the point that we believe that price needs to be the issue over speed.

Now that it appears as though the exchange is moving ever so quickly towards a more competitive, if not almost identical rate of speed, what does that do to the argument?

Chairman BAKER. That will need to be the gentleman's last question, so I can get to Mr. Inslee before we leave for votes. Someone please pick up wherever you might.

Mr. GIESEA. I will quickly respond to that to suggest that should that occur, that is what the objective of the national market system is, in my opinion. It envisions a market that can be seen and accessed on an immediate basis. That is I think the overall envisionment of the national market system.

Mr. CROWLEY. So if you have speed and you have price, there is really no need to change the trade-through rule. Is that correct?

Mr. GIESEA. And accessibility.

Mr. CROWLEY. Thank you.

I yield back.

Chairman BAKER. Mr. Inslee? The gentleman passes.

I will just do some quick follow-ups, and by way of explanation, I would really like to stay for considerably longer and have an exchange. We have either four or five votes, I am not sure which, in a series, so we are going to be over there for a bit. I think it unreasonable to expect you to remain here while we go do that stuff.

I will follow up in written form to a number of you with regard to specific questions. I do believe it the case that the trade-through rule does no in effect result in execution at best price. I do believe that consumers ultimately are the ones we should be concerned

about and should be able to act at their instruction since the markets are actually facilitators of a transaction which is initiated by the initial investor.

To that end, I do not believe that the opt-out rule properly constructed is a bad thing. I will follow these observations up with questions about the triple-Q trade and the ETF transactions in which the SEC eased the rules for a bit, de minimus opportunity to conduct business, and ask for your perspectives on that versus the transitions that occurred in Europe. I am not at all interested in contributing to the demise of our economic system, which has been portrayed as a consequence of looking at facilitated trading. We really do need to have careful consideration, time to do the analysis, and even with Mr. Hinojosa's requests for additional hearings, we certainly will. In the interim, I hope to ask the SEC specifically to help us navigate through this maze with specific data that would be helpful in our insights.

I regret that I do not have time to engage you in more thoughtful discussion today, but given the flow of votes, I think it more appropriate to release you at this point and ask for your response in writing to questions we will formulate over the coming days.

I express my deep appreciation to each of you for your participation here. It has been helpful to the committee's deliberations.

We stand adjourned.

[Whereupon, at 3:21 p.m., the subcommittee was adjourned.]

A P P E N D I X

May 18, 2004

Congressman Joseph Crowley
Remarks --- Trade Thru Rule Hearing
May 18, 2004

- I want to thank the Chairman and Ranking Member for conducting this hearing today on Market Structure and its effects on the Individual Investor

- Unfortunately, I question the wisdom of this panel as there are no actual individual investors being represented here today

- No small investors, no small companies – it's tragic

- My first act when I joined the Financial Services Committee in the winter of 2001 was to work in a bi-partisan way with Congressman Vito Fossella and Congresswoman Carolyn Maloney to pass the Section 31 fee reduction bill to help individual investors

- We, along with this Committee, recognized that it is the individual investors – the little guys – that make our economy hum and they should be who we represent today, but this hearing is only paying lip service to individual investors

- We should be hearing Kurt Stocker of West Cliffe, Colorado, an individual investor about his thoughts on market structure reforms

- I would like to submit his letter for the record

- Or we could hear from the dozens of people and groups who have written and contacted my office from individuals to small firms who worry about the elimination of the Trade Thru Rule or proposed Opt Outs of this Rule that will lead to reductions in investor confidence as they will recognize that their money isn't getting the best deal anymore

- We could listen to the comments of New York City Public Advocate Betsy Gotbaum who argues that it is the right of investors to obtain the best price at all times

- I would like to submit her letter for the record

- Instead we hear from Bloomberg and Scwabb and the American Enterprise Institute and the Council on Foreign Relations or I believe from London-based stock exchange VIRT-X, whichever hat that witness is wearing today

- I think everyone of us recognizes the power of high technology and how it has redefined every sector of American life – Wall Street included

- And I am even supportive of allowing markets to trade through when there are major differences in speed as I too do not believe investors should be left waiting 30 seconds or more for trades to be executed

- But if 2 markets are equal in terms of speed and anonymity then price must be paramount. Markets and broker dealers should not be allowed to Trade Thru best prices because they want to

- How does this benefit individual investors?

- The SEC itself says that their proposed trade-through rule seeks to "affirm the fundamental principle of price priority, while also addressing problems posed by the inherent differences in the nature of prices displayed by automated markets, which are immediately accessible, compared to prices displayed by manual markets."

- Essentially, when sped is equalized, price should take precedence

- But when speed is equal, price must be paramount

- That's what America's individual investors want – the best price in the best time, why would the SEC or Congress try to eliminate this vital consumer protection

- I yield back and hope my colleagues in their questions remember the people we represent and the people this hearing claims to serve today – individual investors

Opening Statement of Congressman Vito J. Fossella
May 18, 2004
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and GSEs
Hearing Entitled: "The SEC Proposal on Market Structure: How Will Investors Fare"

The Securities and Exchange Commission's (SEC) recent proposal to modernize the nation's financial markets remains one of the hottest topics on Wall Street. The proposal, known as Regulation NMS (National Market System), would address four critical issues facing the equities markets: trade-throughs, intermarket access, sub-penny pricing, and market data.

The area that has garnered the most attention has been trade-throughs, the foundation of the equities markets for more than two decades that guarantees small investors the best price available on their trades. That model has served the markets and investors well, but recently it has come under scrutiny as some brokers and dealers argue that technological advancements have made speed – and not price – a more important factor in executing trades.

The SEC has proposed modifications to the trade-through rule that would allow firms trading on electronic markets to opt-out. Under the plan, firms would be empowered to trade on the exchange of their choosing, with best price only one factor in their decision. In other words, small investors may get a fast trade but not necessarily the most cost-effective one.

When speed of execution supersedes best price, the little guy rarely benefits. Here's just one recent example highlighting the problem: A gentleman recently entered an order at 9:29:06 a.m. through an electronic system to sell 1,000 shares of a stock at $5.75. The stock was listed on the Nasdaq, where there is no trade-through rule. After the order was entered and during the time it was displayed, the investor noticed that 30,000 shares traded in lots but all at a higher price than 5.75. However, he did not participate in any of those sales. Because the trade-through rule does not apply to the Nasdaq market, the buyer or buyers of those shares traded through this investor's better offer.

If best price is eliminated from the National Market System, this type of problem will occur all day, across all markets, affecting investor confidence. It will create an uneven playing field for all investors and give an unfair advantage to those investors who are lucky enough to be in the right place at the right time.

Maintaining investor confidence in the capital markets is critical to the long-term prosperity of the U.S. and world economy. There is no question that best price must continue to serve as the underlying principle governing the markets. At this time, no plan has been presented that offers a viable alternative to the trade-through rule that would be more effective guaranteeing small investors the best price.

Fundamentally, we must ensure the markets remain stable, efficient, liquid and transparent. Any rule change must be weighed against its potential to impact these core principles.

We must always look for ways to create incentives for the American people to create, produce and invest. Since the founding of America, economic growth has been fueled by the ingenuity, imagination and vision of our people. To ensure long-term prosperity, we must inspire that entrepreneurial spirit, remove the barriers to capital formation and open the door for all to participate in the financial markets.

Small investors are the backbone of the U.S. economy. Guaranteeing them the best price on trades is one important way we can encourage more people to invest in their future and secure the American Dream.

May 18, 2004

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Hearing entitled, "The SEC Proposal on Market Structure: How will Investors Fare?"

I would like to thank you, Mr. Chairman, for calling this important hearing and allowing us the opportunity to discuss the Securities and Exchange Commission's (SEC) Regulation NMS and particularly their proposal regarding the trade-through rule.

As I indicated in a recent letter to SEC Chairman William Donaldson, I support Regulation NMS and feel it is an appropriate first step toward providing greater transparency and investor choice for all Americans. With regard to the trade-through rule, I do not believe it has evolved with the market to address the needs of modern investors.

I believe that both individuals and institutions, including local and state pension funds in Ohio will benefit from greater control over their trades. The proposed opt out provision would allow educated investors to better tailor their execution to meet their own needs. In addition, the greater choice provided by the modified rule will lead to greater competition between markets. Greater competition inevitably leads to greater transparency as it becomes a factor in where investors choose to execute their trades.

The opt out provision would begin the process of lowering the barriers that inhibit competition and prevent investors from choosing the manner in which their orders are executed. A user-friendly opt-out will allow both big and small investors to benefit from the ability to define best execution in a manner that best addresses their priorities.

Thank you again, Mr. Chairman, for calling this important hearing and I look forward to an informative discussion.

OPENING REMARKS OF THE HONORABLE RUBÉN HINOJOSA
HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON CAPITAL MARKETS
"THE SEC PROPOSAL ON MARKET STRUCTURE: HOW WILL INVESTORS FARE?"
MAY 18, 2004

Chairman Baker and Ranking Member Kanjorski,

I want to thank you for holding an additional hearing to review the structure of our capital markets, in particular the SEC's proposed National Market System (NMS) regulation and how investors will fare under that proposal.

This hearing is very timely in light of the SEC's recent decision to extend the comment period on its NMS proposal and in light of the recent announcement by several different groups to support changes to the trade-through rule.

I have heard from several different groups on the SEC's proposal, and after listening to all of them, I have come to the conclusion that this is a very contentious proposal that seems to have at least four sides to what I originally thought was a two-sided argument. Proponents of the SEC's proposed regulation have told me that the current trade-through rule is antiquated and must be overhauled in order to bring the markets up-to-speed.

Opponents have argued that the NMS proposal would harm investors by promoting timing over best price, which seems to appeal to a particular crowd.

Some associations' representatives have visited me to state their association's official position on the proposal, only to turn around and disagree with their association, which is a bit disconcerting.

Furthermore, certain groups have made comments that are better left unsaid.

Mr. Chairman, our capital markets have long been the envy of the world. They have functioned well over the years. They have endured incredible challenges, voluntarily adapting to new challenges, and occasionally with some encouragement, to new market forces and investors' demands.

It is extremely important that we here in Congress remember the role that we play in this democracy while also ensuring that actions taken by other branches of the government do not harm our constituents, our markets, or our economy.

The SEC has issued its proposed regulation and held a well-attended hearing on it.

They have extended the comment period and will have to review all of the comments they receive and then likely re-propose the NMS regulation for an additional comment period. So, Mr. Chairman, I believe that it is still early in the game.

I look forward to hearing the testimony of today's witnesses to help clarify the arguments for and against the SEC's proposed National Market System.

Chairman Baker, I also look forward to hearing investors' opinions of the SEC's proposal in the future if the Committee's schedule permits their appearance.

Mr. Chairman, I yield back the remainder of my time.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

THE SEC'S PROPOSALS ON MARKET STRUCTURE: HOW WILL INVESTORS FARE?

TUESDAY, MAY 18, 2004

Mr. Chairman, we meet for the fourth time in the 108th Congress to review the organization of our capital markets and evaluate the need for further reforms in light of technological advances and competitive developments. This hearing seeks to examine how the market structure changes recently proposed by the Securities and Exchange Commission will affect investors.

As I have regularly observed at our previous hearings, a variety of agents in our equities markets have questioned one or more aspects of the regulatory system during the last several years. We have also, in my view, come to a crossroads in the securities industry, confronting a number of decisions that could fundamentally alter its organization for many years to come.

We have elaborately interconnected systems and relationships in our equities markets. I therefore believe that we should heed the philosophy of Edmund Burke and refrain from pursuing change for change's sake. We should only modify the structure of our securities markets if it will result in improvements for investors. The Chairman of the Securities and Exchange Commission has also recently observed that in pursuing any change to fix those portions of our markets experiencing genuine strain, we must ensure that we do not disrupt those elements of our markets that are working well.

In February, the Commission put forward for discussion four interrelated proposals that would reshape the structure and operations of our equities markets. Because these proposals have generated considerable debate, the Commission announced last week that it would extend the public comment period until the end of June.

In adopting the Securities Acts Amendments of 1975, the Congress wisely decided to provide the Commission with a broad set of goals and significant flexibility to respond to market-structure issues. From my perspective, this legal framework has worked generally well over the last three decades. It is also appropriate for the Commission at this time to review its rules governing market structure and for our panel to conduct oversight on these matters.

Mr. Chairman, as you already know, I have made investor protection one of my highest priorities for my work on this Committee. Although many of the agents in our securities markets have called for adopting market-structure reforms and some of them may benefit from these changes, the Commission must thoroughly examine the effects of its reform proposals on average retail investors before approving any change.

Today, I suspect that many of our witnesses will discuss the Commission's proposal to alter the trade-through rule. Retail investors are guaranteed the best price that our securities markets have to offer regardless of the location of a trading transaction under our present

regulatory system. By ensuring fair treatment, this best-price guarantee has significantly increased confidence in our securities markets. I also believe that this directive has served most investors generally well.

The Commission, however, has issued a proposal to permit participants in our capital markets to opt out under certain circumstances of this best-price guarantee. Some have suggested that this proposal could potentially produce unintended consequences like fragmenting our securities markets, decreasing liquidity, and limiting price discovery. Because such results could prove deleterious for small investors, I will be monitoring this issue very closely in the weeks and months ahead.

A recent survey of older American investors also found that 86 percent of the respondents agreed that they should be alerted before the completion of a transaction in which the best available price is not the top priority. I would consequently like to learn from our witnesses how unsophisticated investors should be notified if their mutual fund manager, stock broker, or pension fund adviser decides to opt out of the present best-price mandate. For example, it would be helpful to debate whether such opt outs should be completed via a blanket disclosure or on a per trade basis.

In sum, Mr. Chairman, we should continue to conduct vigorous oversight of our equities markets to determine whether or not the present regulatory structure is working as intended and to study how we could make it stronger. The observations of today's witnesses about these complex matters will further help me to discern how we can maintain the efficiency, effectiveness and competitiveness of our Nation's capital markets into the foreseeable future.

Statement of Matthew Andresen

Former CEO, Island ECN

U.S. House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

May 18, 2004

I commend the Chairman and the Members of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises for holding these hearings on the SEC's proposed changes to U.S. Equity Market structure. We are at a crossroads in the history of our markets, and much depends on the decisions we now make. The two overarching issues addressed in the SEC's RegNMS proposal- trade through relief and market data reform- are of crucial importance to the American investor. We have an historic opportunity to create fairer, more competitive markets that ensure that America's role as the financial center of the world continues well into the future.

The world of U.S. Equity trading has been split into two camps for decades. In one camp, the NYSE-Listed world, human and manual driven processes rule. This camp has evolved over time to suit the humans that drive it. The rules, regulations, and trading strategies in this world have all been shaped over time to ensure the primacy of the upstairs Listed trading professionals and the Floor community. In the other camp, the OTC world, electronic immediacy has become the standard for price discovery. The rules, regulations, and trading strategies in this world have evolved over time to favor electronic markets and their users.

Technology has widened the chasm between these two disparate market structures. Technology drove the overhaul of the OTC market after the SEC's sweeping Order Handling Rules in 1997. Seven years later, virtually every OTC quote in the market is a firm indication to trade, and is readily available for auto-execution. This contrasts

sharply with the NYSE, where Specialists are given the opportunity to interact selectively with orders in exchange for agreeing to keep an orderly market.

Interestingly, while technology was responsible for further widening the chasm between the OTC and Listed worlds, it is now the primary factor pushing them together again. New technologies like Lava Trading Floor have made it possible to interact with both marketplaces through a common interface. This has led most big Wall Street trading desks to ditch the old model of separate OTC and Listed trading desks that rarely interacted. Now, the desks are "sectorized," meaning that the desks are divided up by stock industry sector (a much more rational result). This change has illuminated the stark differences in speed and certainty between the Listed and OTC markets. Because the trader trading DELL on Nasdaq is for the first time the same trader trading HPQ on the NYSE, there is a bridging of the two trading worlds.

The OTC and Listed Sell-Side broker business have been further mixed with the rise in Program Trading. Program Trading has enabled Asset Managers to execute lists of many stock orders all at once, which makes better risk management and execution quality management possible. The lists of stocks to be executed by a Program Trading desk are inevitably mixtures of both OTC and Listed stock names. Because of this phenomenon, the same execution pathway is being used for the first time for both OTC and Listed executions.

Technology has also enabled the explosion of a new industry: electronic modeling. Electronic modelers employ sophisticated techniques to run limit-order intensive strategies in the market. These players place millions of liquidity enhancing orders a day into the market. Examples of common strategies include Statistical Arbitrage and Index Arbitrage. Modelers now provide a very significant percentage of liquidity in the marketplace, leading electronic marketplace to compete aggressively for their business. This has given them great power over the features and benefits of the electronic marketplaces.

Technology has also made it easier to deliver new electronic trading services. Electronic Communications Networks arose in 1997 after the SEC's Order Handling rules. These new entrants into the OTC market remade the market entirely. Whereas before their arrival the OTC market was infamous for wide spreads, non-firm quotes, and gaming, today the OTC market has the tightest spreads, virtually only firm quotes (only the recent scattered quoting by the traditional American Stock Exchange is an exception), and pathological competition. The ECN's were remade into Alternative Trading Systems (ATS's) with RegATS in 1998. The ATS's remade the OTC marketplace, but did not make significant forays into the Listed marketplace until 2000 and 2001.

The first real success enjoyed by an electronic market in the Listed environment was by my old company, Island ECN, in the ETF's. There were several factors that made this success in the ETF's easier than succeeding in the NYSE-Listed world. One, ETF's are derivatively prices instruments. They are therefore less dependent on the central price

discovery process of any one market. Instead, they are priced off of the values of their underlying stocks and the price of the futures instruments that track the same indices. Two, because of the nature of these derivatively prices instruments, price changes are often more rapid than in most individual stocks. This puts a premium on speed, reliability, and certainty of execution- metrics that are in the power alley of a top ATS. Third, the customers who make the best use of ETF's were already heavy users of ATS's, and were predisposed to understand and make use of the particular benefits that ATS's provide.

As the ECN's, in particular Island, quickly grew to dominate the American Stock Exchange and the NYSE in ETF trading, the SEC correctly realized that the two disparate trading worlds could no longer exists in separate orbits. The traditional human driven Listed markets and the electronically driven OTC markets were in the midst of the first true battle in a very long war for the control of the future of U.S. equity trading.

Wisely, the SEC has moved in recent months to address the disparities between the markets. For instance, their recent short sale proposal addressed the differences in short sale treatment between the two markets. Now, we have the RegNMS proposal. Among may things, it seeks to address two key inefficiencies in the marketplace: Trade-through and Market Data.

The Trade-through rule prohibits an Exchange from consummating a trade in a Listed security at a price inferior to one displayed on another Exchange. While this might

appear sensible on first blush, the rule does not address a central tenet of market economics: There is not one sole criterion for value. Advertised price does not, for instance equate with true price. Suppose you have the choice between two identical Ford Mustangs. Both are brand new, both have identical features. But one is selling for $20,000, and the other is selling for $19,000. Which one would you want? The only correct answer in my book is "I don't have enough information to make that decision."

Why? Because there are other factors that affect not the *advertised* price of the car, but rather the *true* price. Suppose the $19,000 car was in California, but the $20,000 one was right here in Washington, DC. It might very well cost more than $1,000 to ship the car from California to where you could actually use it, so when the *true* prices of the cars are tallied, the one with the lower *advertised* price is actually more expensive! This simplistic example could only understate the degree of variance in the stock market between true and advertised price. Factors such as time, certainty of execution, implicit fees, adverse selection, and reliability make advertised prices only a small part of the execution story.

It is the job of every trader and every broker to make the tough calculations of value necessary to get the investor the best *true* price. It should not be the job of an Exchange or ATS to do that job for them. The ATS's and Exchanges are very good at creating the best possible destinations for orders through innovation and competition. The traders and brokers in this country are as a group highly adept and figuring out what the real best price is for a customer. Mixing these roles stifles competition and innovation, slowing

the marketplace down the lowest common denominator. Trade-through, I have often said, is equivalent to sending a dozen people off to climb a tall mountain, but first tying them together with a rope. If one falls, they all fall. If one feels like sitting down and making the rest carry him to the top, he can. This is not a solution worthy of our markets, and the SEC deserves credit for identifying this problem in RegNMS.

RegNMS proposes to make one trade-through rule for both the OTC and Listed worlds. Currently, there is no trade-through rule at all in the Nasdaq-listed market. RegNMS includes language for potential rules for both OTC and Listed trading. However, they ask for extensive public comment on what actual changes will be needed to make these rules work effectively. The SEC recognizes that there are many ways to address each issue in the proposal, and rightly asks for comments on the various options.

The key proposal in my opinion is a concept that would greatly enhance investor power and choice over their trades: an "opt out" exception. This exception would allow informed investors to choose, on an order-by-order basis, to opt out of being forced to have their orders sent to a market that may have the best advertised price when investors believe that chasing this price, which may not be available, is not in their best interests. An investor's broker would be required to obtain the investor's informed consent prior to executing an order pursuant to this exception. The SEC's idea is that an informed investor should have more choice in how their trades and executed is the correct one. Whenever choice exists in a market for service, the best service wins and the standard for all service rises.

While the opt-out clause holds out the promise of a major step forward for the markets, much will depend on the wording of the final rule. The SEC must make the actual process of opting out on a particular order as simple as possible, in order to make the actual process simple to implement and the rule straight forward to comply with. The fact is, the value of this exception is contingent on its ease of use and implementation: the more difficult it is to opt out, the less valuable the exception will be.

The other main topic addressed in RegNMS involves Market Data Revenue. Historically, the vast sums made off the collection and dissemination of stock quotes and trade information are shared among the Exchanges on the basis of their market share of reported trades. This is an imperfect system, as I noted in a letter to the SEC in early 2002, before we started sharing this market data revenue with our customers. It equates the value of a 100 share trade with the value of a 1,000,000 share trade. The information value of these two trades is not equal. I don't have any penetrating insights on potential formulas or structures for this data revenue sharing process. The more central question is how this data should actually be priced. What is the right price for market data? I believe that the correct answer to that question can only be answered by the free market.

Mr. Chairman, it is an honor to have had this chance to present my perspective on these critical public-policy issues. These hearing today, and the SEC's timely RegNMS proposals, present all of us with a compelling opportunity to shape the future of our Nation's equity markets and ensure their continued strength and prosperity. As we

consider the various proposals under discussion, we must be careful to embrace the competitiveness and innovation which has made our markets the envy of the world.

TESTIMONY OF MR. KIM BANG

PRESIDENT AND CHIEF EXECUTIVE OFFICER

BLOOMBERG TRADEBOOK LLC

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

HOUSE COMMITTEE ON FINANCIAL SERVICES

REGARDING

"THE SEC PROPOSAL ON MARKET STRUCTURE: HOW WILL INVESTORS FARE?"

MAY 18, 2004

INTRODUCTION. MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE. MY NAME IS KIM BANG, AND I AM PLEASED TO TESTIFY ON BEHALF OF BLOOMBERG TRADEBOOK REGARDING "THE SEC PROPOSAL ON MARKET STRUCTURE: HOW WILL INVESTORS FARE?" THE TOPIC IS BOTH IMPORTANT AND TIMELY.

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SECURITIES IN 85 COUNTRIES, MORE THAN 50,000 COMPANIES TRADING ON 82 EXCHANGES AND MORE THAN 406,000 CORPORATE BONDS. BLOOMBERG NEWS IS SYNDICATED IN OVER 350 NEWSPAPERS, AND ON 550 RADIO AND TELEVISION STATIONS WORLDWIDE. BLOOMBERG PUBLISHES MAGAZINES AND BOOKS ON FINANCIAL SUBJECTS FOR THE INVESTMENT PROFESSIONAL AND NON-PROFESSIONAL READER.

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BLOOMBERG TRADEBOOK SPECIALIZES IN CONSOLIDATING WHAT HAS BEEN A FRAGMENTED MARKET BY INCREASING TRANSPARENCY AND ACCESS TO LIQUIDITY. OUR CLIENTS HAVE REWARDED OUR CREATIVITY AND OUR SERVICE BY TRUSTING US WITH THEIR BUSINESS, ENABLING US TO REGULARLY TRADE MORE THAN 150 MILLION SHARES A DAY.

REGULATION NMS. THE HOUSE FINANCIAL SERVICES COMMITTEE HAS LONG UNDERSTOOD HOW SEEMINGLY ABSTRACT MARKET STRUCTURE ISSUES HAVE A DIRECT BEARING ON THE EFFICIENCY AND

COMPETITIVENESS OF OUR MARKETS AND THE INTERESTS OF INVESTORS. THE COMMITTEE'S INTEREST IN THE SEC'S LANDMARK "REGULATION NMS" PROPOSAL IS WELCOME AND WARRANTED.

THE SEC IS TO BE COMMENDED FOR ISSUING PROPOSED REGULATION NMS FOR PUBLIC COMMENT. THE REGULATION IS AN AMBITIOUS EFFORT TO ENGAGE POLICY MAKERS, MARKET PARTICIPANTS AND THE PUBLIC IN A DEBATE OVER HOW BEST TO PROMOTE THE LONG OVERDUE MODERNIZATION OF THE U.S. EQUITY MARKETS.

IN EARLIER MARKET STRUCTURE HEARINGS, CHAIRMAN OXLEY ASKED "WHY DOES THE NYSE CONTROL 80 PERCENT OF THE TRADING VOLUME OF ITS LISTED COMPANIES WHEN NASDAQ CONTROLS ONLY ABOUT 20 PERCENT OF THE VOLUME OF ITS LISTED COMPANIES?" THE ANSWER IS SIMPLE — THERE HAVE BEEN AND CONTINUE TO BE NUMEROUS IMPEDIMENTS TO ELECTRONIC COMPETITORS.

FROM THE ONLY RECENTLY DISCARDED RULE 390, WHICH SUBSTANTIALLY RESTRICTED NYSE MEMBER FIRMS FROM TRADING STOCKS OF COMPANIES THAT LISTED BEFORE APRIL 1979 ANYWHERE BUT ON THE EXCHANGES, TO THE NOW RESCINDED RULE 500, WHICH MADE IT EXTREMELY DIFFICULT FOR A LISTED COMPANY TO DELIST, THESE

BARRIERS HAVE HAD THE EFFECT OF CENTRALIZING ORDER FLOW, AND IMPAIRING INTER-MARKET COMPETITION.

THE NASDAQ PRICE-FIXING SCANDAL OF THE MID 1990S RESULTED IN SANCTIONS BY THE SEC AND THE DEPARTMENT OF JUSTICE AND DECISIONS ON MARKET STRUCTURE INTENDED TO ENHANCE TRANSPARENCY AND COMPETITION IN THE NASDAQ MARKET. SPECIFICALLY THE SEC'S 1996 ISSUANCE OF THE ORDER-HANDLING RULES PERMITTED ELECTRONIC COMMUNICATIONS NETWORKS — ECNS — TO FLOURISH, BENEFITING INVESTORS AND ENHANCING THE QUALITY OF THE MARKET.

INDEED, THE INCREASED TRANSPARENCY PROMOTED BY THE SEC'S ORDER-HANDLING RULES AND THE SUBSEQUENT INTEGRATION OF ECNS INTO THE NATIONAL QUOTATION MONTAGE NARROWED NASDAQ SPREADS BY NEARLY 30% IN THE FIRST YEAR FOLLOWING ADOPTION OF THE ORDER-HANDLING RULES. THESE, AND SUBSEQUENT REDUCTIONS IN TRANSACTIONAL COSTS, CONSTITUTE SIGNIFICANT SAVINGS THAT ARE NOW AVAILABLE FOR INVESTMENT THAT FUELS BUSINESS EXPANSION AND JOB CREATION.

THE QUESTION CONFRONTING THE SEC AND CONGRESS IS WHETHER OUR EQUITY MARKETS CAN BE REFORMED TO BRING THE SAME

BENEFITS TO THE NYSE INVESTOR AS THEY HAVE TO THE NASDAQ INVESTOR. THE TRADE-THROUGH RULE IS THE FOREMOST IMPEDIMENT TO THAT OPPORTUNITY.

THE TRADE-THROUGH RULE. THE TWENTY-YEAR-OLD TRADE-THROUGH PROVISION OF THE INTER-MARKET TRADING SYSTEM PLAN STATES THAT WHEN THE SPECIALIST OR MARKET MAKER RECEIVES AN ORDER, IT CANNOT EXECUTE IT AT A PRICE INFERIOR TO ANY FOUND ON ANOTHER MARKET WITHOUT GIVING A "FILL" TO THE BETTER-PRICED ORDER. TWENTY YEARS AGO INVESTORS DID NOT HAVE DIRECT MARKET ACCESS AND COULDN'T CHOOSE BETWEEN PRICE, LIQUIDITY AND SPEED, BECAUSE SOPHISTICATED ROUTING AND EXECUTION TECHNOLOGY DID NOT EXIST. TODAY, TECHNOLOGY PROVIDES THOSE OPTIONS, BUT THE TRADE-THROUGH RULE STYMIES CHOICE AND COMPETITION — FORCING INVESTORS TO GO THROUGH SLOWER, MANUAL MARKETS WITH INFERIOR AND MORE EXPENSIVE EXECUTION RESULTS.

THAT MAY HAVE MADE SOME SENSE BEFORE SYSTEMS AUTOMATION AND DECIMALIZATION — WHEN THERE WERE ONLY MANUAL MARKETS AND EIGHT PRICE POINTS PER DOLLAR. TODAY, ORDER ROUTING TECHNOLOGY ENABLES SPEED AND CERTAINTY OF EXECUTION THAT IS MORE IMPORTANT TO MOST INVESTORS THAN ATTEMPTING TO CAPTURE THE LAST PENNY. CERTAINTY OF EXECUTION

FAR OUTWEIGHS THE RISK OF MISSING THE PRICE AND LOSING THE TRADING OPPORTUNITY ALTOGETHER.

CURRENTLY, THE INTERMARKET TRADING SYSTEM TRADE-THROUGH RULE PROTECTS INEFFICIENT MARKETS WHILE DEPRIVING INVESTORS OF THE CHOICE OF ANONYMITY, SPEED OR LIQUIDITY BY MANDATING INSTEAD THAT INVESTORS PURSUE THE ADVERTISED THEORETICAL "BEST PRICE" INSTEAD OF THE BEST AVAILABLE FIRM PRICE.

ONE QUESTION THAT PUZZLES US IS WHY IT SEEMS THE EXISTING RULE — AND THE SEC'S PROPOSED RULE AS WELL — FAIL TO PROTECT LIMIT ORDERS IN AT LEAST THREE WAYS:

1. THEY DO NOT ACCORD TIME PRIORITY TO LIMIT ORDERS THAT HAVE ALREADY BEEN PLACED;

2. THEY PERMIT ANOTHER MARKET CENTER TO "MATCH" PRE-EXISTING LIMIT ORDERS—WHICH EFFECTIVELY DENIES LIMIT ORDER ENTRANTS THE REWARD THEY SHOULD GET FOR, IN EFFECT, HAVING GRANTED THE MARKET FREE "OPTIONS" (PUTS IN THE CASE OF A LIMIT ORDER TO BUY, CALLS IN THE CASE OF A LIMIT ORDER TO SELL). THAT PERMITS EXCHANGES SUCH AS THE NYSE TO MATCH AND THEN

INTERNALIZE ORDERS RATHER THAN TO SHIP THEM TO OTHER MARKET CENTERS THAT HAD OFFERED BETTER PRICES; AND

3. LIMIT ORDERS ARE NOT PROTECTED AGAINST "PENNYING" — BY WHICH NYSE SPECIALISTS AND OTHER FLOOR MEMBERS JUMP AHEAD OF ORDERS BY TRIVIAL AMOUNTS — A PENNY OR TWO. THIS IS ONE OF THE NEGATIVE FALLOUTS OF THE MOVE TO DECIMAL MARKETS.

WE SHARE WITH SINCERE PROPONENTS OF TRADE-THROUGH RULES A VISION OF A NATIONAL MARKET SYSTEM THAT PROMOTES ORDER INTERACTION AND TREATS ALL ORDERS AND ALL INVESTORS FAIRLY. WE EMBRACE WHOLEHEARTEDLY A MARKET STRUCTURE THAT PROTECTS ALL PARTICIPANTS, LARGE AND SMALL. WERE A TRADE-THROUGH RULE EFFECTIVE AND NECESSARY TO ACHIEVE THESE ENDS, WE WOULD SUPPORT IT WITHOUT RESERVATION.

THE REALITY, HOWEVER, IS THAT THE EXISTING TRADE-THROUGH RULE DOES NOT PROVIDE ANY MEANINGFUL INVESTOR PROTECTION AND IS AN IMPEDIMENT TO ACHIEVING BEST EXECUTION. IT HAS STOOD IN THE WAY OF INNOVATIVE TECHNOLOGY AND DETERRED INVESTORS FROM OBTAINING DIRECT ACCESS TO MARKET DATA AND LIQUIDITY. AS ARCHIPELAGO'S GERALD PUTNAM HAS TESTIFIED BEFORE THIS COMMITTEE:

. . . EMPIRICAL DATA SHOWS THAT THE NYSE TROTS OUT THE TRADE THROUGH RULE WHEN IT SUITS ITS COMPETITIVE PURPOSES, BUT IGNORES IT WHEN IT DOES NOT. HERE ARE SOME FACTS: ARCAEX RUNS SOFTWARE (APTLY NAMED "WHINER") THAT MESSAGES ALERTS WHEN EXCHANGES TRADE THROUGH AN ARCAEX QUOTE IN VIOLATION OF THE ITS PLAN. THE WHINER DATABASE REFLECTS THAT ARCAEX CUSTOMERS SUFFERED UP TO 7,500 TRADE-THROUGH VIOLATIONS IN A SINGLE WEEK BY THE NYSE. IN FACT, TRADE-THROUGH VIOLATIONS HAVE ACTUALLY RISEN MOST RECENTLY DESPITE THE GLARE OF THE REGULATORY SPOTLIGHT ON THE NYSE. SINCE JUST THIS LAST THE [SIC] FALL (2003), THE ANNUALIZED COST TO INVESTORS OF THE NYSE SPECIALISTS TRADING THROUGH ARCAEX'S QUOTES HAS INCREASE 3-FOLD FROM APPROXIMATELY $1.5 MILLION TO $5 MILLION. ON ANY GIVEN DAY, ARCAEX HAS A BILLION SHARES ON OR NEAR THE NATIONAL BEST BID OR OFFER. YET ON ANY GIVEN DAY, THE NYSE SENDS ONLY 2 MILLION SHARES TO ARCAEX OVER ITS WHEN WE HAVE THE BEST PRICE.

WE HAVE CONFRONTED THE NYSE WITH OUR VOLUMINOUS DATA BUT TO NO AVAIL. IF, IN THE NYSE'S OWN WORDS, THE TRADE THROUGH RULE "SERVES TO PROTECT INVESTORS," THEN THE NYSE HAS SOME "SPLAINING" TO DO AND NEEDS TO TAKE CORRECTIVE

ACTION FORTHWITH TO ENFORCE AND COMPLY WITH THE TRADE THROUGH RULE IN ITS OWN MARKETPLACE.[1]

THE TRADE-THROUGH RULE IN PRACTICE HAS BEEN A ONE-WAY STREET, WITH THE NYSE ITSELF AS THE HEAVY-HANDED TRAFFIC COP. TO BE SURE, THE NYSE GOES AFTER REGIONAL MEMBERS THAT TRADE THROUGH NYSE PRICES. NONETHELESS, THE NYSE'S SPECIALISTS ROUTINELY TRADE THROUGH BETTER PRICES ON OTHER MARKETS AND, AS A PRACTICAL MATTER, THEY DO SO WITH IMPUNITY.

FOR THEIR PART, THE REGIONAL MARKET CENTERS TEND TO COMPLY WITH THE CURRENT TRADE-THROUGH RULE WHILE AT THE SAME TIME THEY ARE NOT ABLE TO PROTECT THEIR CLIENT LIMIT ORDERS FROM BEING TRADED THROUGH BY THE PRIMARY MARKET. THEY ARE FURTHER DISADVANTAGED BECAUSE THEY ARE NOT PERMITTED TO EXECUTE INCOMING ORDERS ROUTED FOR EXECUTION AGAINST THEIR CUSTOMER LIMIT ORDERS WHEN THOSE ORDERS ARE DISPLAYED AND AVAILABLE, BUT AWAY FROM THE NBBO. THE INTERMARKET TRADING SYSTEM TRADE-THROUGH RULE REQUIRES THAT

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1 Written statement of Gerald Dean Putnam, Chairman & Chief Operating Officer, Archipelago Holdings, L.L.C., concerning "Market Structure III: The Role of the Specialist in the Evolving Modern Marketplace" before Committee on Financial Services -- Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, United States House of Representatives, 108th Cong., 2d Sess., February 20, 2004, at p. 6

REGIONAL EXCHANGES AND ECNS REROUTE THOSE ORDERS TO THE PRIMARY EXCHANGE.

IN THE CASE OF NASDAQ-LISTED STOCKS, WE AT BLOOMBERG TRADEBOOK HAVE PLENTY OF PRACTICAL EXPERIENCE WITH HOW AND WHEN OUR CLIENTS CHOOSE TO TRADE THROUGH PUBLISHED PRICES. IN OUR EXPERIENCE, THE ONLY MARKET CENTERS OUR CLIENTS REGULARLY CHOOSE TO TRADE THROUGH OR AROUND ARE THE AMERICAN STOCK EXCHANGE (THE "AMEX") AND CERTAIN ECNS. OUR CLIENTS TRADE AROUND THE AMEX BECAUSE THE AMEX POSTS INDICATIVE QUOTATIONS AND IS SLOW TO RESPOND TO ORDERS. SOME OF OUR CLIENTS TRADE AROUND ONE OR TWO SMALLER ECNS THAT CHARGE EXORBITANT ACCESS FEES.

BEFORE THE ADVENT OF SUPERMONTAGE, IT WAS COMMON PRACTICE FOR OUR CLIENTS TO PREFERENCE ECNS FOR THEIR IMMEDIACY. AT THE TIME, NASDAQ DISPLAYED INDICATIVE MARKET-MAKER QUOTATIONS THAT WERE NOT AUTOMATICALLY EXECUTABLE. OFTEN, THE MARKET MAKERS TOOK UP TO 30 SECONDS TO EXECUTE OR DECLINE AN ORDER. EVEN THEN, IT WAS RARE FOR OUR CLIENTS TO COMPLETELY IGNORE OR TRADE THROUGH MARKET-MAKER QUOTATIONS. RATHER, THE MARKET MAKERS TENDED TO RECEIVE A PROPORTIONATELY SMALLER AMOUNT OF ORDER FLOW. THAT

OCCURRED BECAUSE, COMPARED WITH ECN ORDERS, THEIR QUOTATIONS WERE LESS FIRM. WITH THE SUBSEQUENT LAUNCH OF SUPERMONTAGE, MARKET MAKER QUOTATIONS HAVE BEEN CONVERTED TO ORDERS AND ARE NOW FIRM. AS A RESULT, OUR CLIENTS TREAT SUPERMONTAGE ORDERS ON EQUAL FOOTING WITH ECN LIMIT ORDER BOOKS.

THE TECHNOLOGY IS IN PLACE. THE ORDER-MANAGEMENT SYSTEMS, ORDER-ROUTING TECHNOLOGIES, CONNECTIVITY AND SERVICE BUREAUS THAT BROKERS AND INVESTORS TODAY WIDELY EMPLOY LET THEM REACH EVERY LIQUIDITY VENUE. THESE SYSTEMS ARE DESIGNED FOR BROKERS AND INVESTORS TO SEEK BEST EXECUTION AT THE LOWEST COST. THESE SYSTEMS LET TRADERS PREFERENCE OR PRIORITIZE ORDERS ON THE BASIS OF COST, RESPONSE TIMES AND OTHER RELEVANT LIQUIDITY PARAMETERS. IN OUR EXPERIENCE, INVESTORS DO NOT ROUTINELY TRADE THROUGH FAST MARKETS. ONLY SLOW MARKETS ROUTINELY TRADE THROUGH FAST MARKETS — AND THAT IS NOT BECAUSE THEY CANNOT ACCESS FAST MARKETS. IT IS BECAUSE THEY CHOOSE NOT TO.

IF TRADE-THROUGH PROTECTION FOR FAST MARKETS IS NOT NECESSARY AS A GENERAL MATTER, THEN A *DE MINIMIS* TRADE-THROUGH RULE, THAT IS, A TRADE-THROUGH RULE THAT ALLOWS A FAST MARKET TO TRADE THROUGH A SLOW ONE BY JUST A LITTLE BIT, ALSO IS

UNNECESSARY. IN A MARKETPLACE WHERE BROKERS AND FIDUCIARIES ARE OBLIGATED TO SEEK BEST EXECUTION, THE REGULATORY AND FINANCIAL INCENTIVE IS IN PLACE TO SEEK THE BEST PRICE. THE PROGRAMMING REQUIRED BY THE MARKET CENTERS TO ENSURE THAT NO TRADE-THROUGH OCCURS AMOUNTS TO EXPENSIVE REGULATORY AND SYSTEMS OVERKILL WITH NO COMMENSURATE BENEFIT TO INVESTORS.

INDEED, THE COMMISSION'S OWN PRELIMINARY ESTIMATES OF THE SECURITIES INDUSTRY'S COSTS OF COMPLIANCE WITH THE PROPOSED TRADE-THROUGH RULE ARE EYE-POPPING. START-UP COSTS ARE PROJECTED TO RUN IN EXCESS OF $540 MILLION, WHILE ANNUAL, ONGOING COSTS OF COMPLIANCE ARE PROJECTED AT NEARLY $224 MILLION.

A TRADE-THROUGH RULE, IN ADDITION TO BEING WASTEFUL, MAY ALSO BE HARMFUL TO INVESTORS. CONSIDER FIRST THAT SLOW MARKETS WILL FREELY CHOOSE TO BE SLOW MARKETS. THERE MAY BE LITTLE INCENTIVE FOR A MARKET TO ELECT TO BECOME A FAST MARKET IF SLOW MARKETS ARE TO RECEIVE TRADE-THROUGH PROTECTION— EVEN DE MINIMIS PROTECTION. SUCH SLOW MARKETS MAY HAVE GENUINE BENEFITS FOR PARTICIPANTS IN TERMS OF PRICE FORMATION AND LIQUIDITY. BUT THESE BENEFITS OUGHT TO ACCRUE ONLY AS THE

RESULT OF COMPETITION. THAT WOULD MEAN THAT THE SLOW MARKET PARTICIPANTS THEMSELVES WOULD HAVE TO BEAR THE ATTENDANT COST, FOR EXAMPLE, IN THE FORM OF MISSED TRADING OPPORTUNITIES. THE ALTERNATIVE WOULD BE TO PERPETUATE TRADE-THROUGH RULES THAT WOULD ALMOST CERTAINLY IMPOSE A MUCH HIGHER COST THAT WILL CONTINUE TO BE BORNE BY THE ENTIRE INVESTOR UNIVERSE OF FAST MARKET PARTICIPANTS.

TO BE SURE, ONLY SLOW MARKETS THAT OFFER REAL BENEFITS WILL BE WORTH THE SACRIFICE OF FAST-MARKET TRADING OPPORTUNITIES. IN OPEN COMPETITION, THE BENEFITS WILL HAVE TO OUTWEIGH THE COSTS. THE FAIREST WAY TO FACILITATE THAT RESULT IS TO PROMOTE ENHANCED INVESTOR AND FIDUCIARY CHOICE AND HAVE THEM BEAR THE COSTS AND REGULATORY RISK OF THEIR OWN BEST EXECUTION CHOICES.

IF THE TRADE-THROUGH RULE WERE ABOLISHED FOR STOCKS LISTED ON THE NYSE, WE EXPECT OUR CLIENTS WOULD PREFERENCE THE FAST-MARKET VENUES (FIRM QUOTATIONS), BUT WOULD NOT IGNORE SLOW MARKETS (INDICATIVE QUOTATIONS) TO THE EXTENT THEY AFFORDED AVAILABLE LIQUIDITY. FAST MARKETS WOULD AUTOMATICALLY EXECUTE AGAINST THEIR LIMIT ORDER BOOKS AND REFRESH THEIR QUOTATIONS IMMEDIATELY AND THEREBY EARN

PROPORTIONATELY MORE ORDER FLOW OVER TIME. ORDERS RESIDING ON THE SLOW MARKETS BEYOND THE TOP-OF-FILE AND HIDDEN ORDERS IN THE CROWD WOULD BE TRADED THROUGH, AND RIGHTLY SO. IF THE TRADE-THROUGH RULE WERE ELIMINATED, THE OPTION THAT SPECIALISTS CURRENTLY ENJOY, WHICH IS BOTH RISKLESS AND FREE, TO INTERCEPT INCOMING ORDERS, TO JUMP AHEAD BY A PENNY OR TO "GO ALONG" WITH INSTITUTIONAL ORDERS, WOULD BE DIMINISHED. SPECIALISTS WOULD THEN HAVE TO COMPETE ON AN EVEN BASIS WITH OTHER MARKET PARTICIPANTS TO SATISFY INVESTORS' DEMANDS FOR BEST EXECUTION.

REMOVING THE TRADE-THROUGH RULE WOULD ALLOW INVESTORS TO CHOOSE THE MARKETS IN WHICH THEY WISH TO TRADE WHICH WOULD, IN TURN, PROMOTE COMPETITION AND BENEFIT INVESTORS. THE RESULTS WOULD BE GREATER TRANSPARENCY, GREATER EFFICIENCY, GREATER LIQUIDITY AND LESS INTERMEDIATION IN THE NATIONAL MARKET SYSTEM, WHICH ARE PRECISELY THE GOALS OF THE SECURITIES ACTS AMENDMENTS OF 1975.

AS A RESULT, WE BELIEVE THE BEST OUTCOME FOR THE MARKETS WOULD BE FOR THE COMMISSION TO ELIMINATE THE TRADE-THROUGH RULE ENTIRELY. IF THERE IS TO BE A TRADE-THROUGH RULE, HOWEVER, IT IS ESSENTIAL THAT THERE BE OPT OUTS. AN OPT OUT IS NECESSARY

TO PERMIT BROKERS AND FIDUCIARIES TO MEET THEIR BEST EXECUTION OBLIGATIONS.

THE ALTERNATIVE OPT-OUT PROVISION, FOR FAST MARKETS OPTING OUT OF SLOW MARKETS WITHIN A STATED PRICE BAND, RAISES SOME ISSUES. JUST AS THE SHORT SALE RULE PRESENTS PRACTICAL PROBLEMS IN A DECIMALIZED MARKET CHARACTERIZED BY FLICKERING QUOTES, WE WONDER WHETHER THE FAST-TO-SLOW OPT OUT WOULD PRESENT A SIMILAR OR EVEN GREATER PROBLEM OF IMPLEMENTATION. THE SLIDING SCALE OF PERMISSIBLE TRADE-THROUGH PRICING WOULD MAKE IMPLEMENTATION ALL THE MORE COMPLICATED. ALSO, WE WONDER WHETHER IT IS SENSIBLE FOR THE GOVERNMENT TO DECREE WHAT IS FAST ENOUGH TO BE FAST. A MARKET-DRIVEN DETERMINATION MIGHT WELL RELY ON COMPETITION AMONG MARKET CENTERS TO EMBRACE TECHNOLOGY IN PLACE OF A GOVERNMENT MANDATE.

IF THE COMMISSION WERE TO WITHDRAW THE UNRESTRICTED OPT OUT IN FAVOR OF THE FAST-TO-SLOW OPT OUT, WE THINK THE CURRENT EXEMPTION FOR BLOCK TRADES SHOULD BE RETAINED GIVEN THE LIMITATIONS OF PUBLISHED LIQUIDITY.

IF THERE IS TO BE A TRADE-THROUGH RULE, A SOLUTION WILL HAVE TO BE FOUND TO PREVENT MARKET CENTERS FROM REJECTING

AND REROUTING ORDERS THEY HAVE MISPERCEIVED AS TRADE THROUGHS. IF THIS PROBLEM WERE SOLVED, IT MIGHT SUBSTANTIALLY DIMINISH THE NEED FOR AN OPT OUT.

RATHER THAN INTRODUCING A COMPLEX AND EXPENSIVE NEW TRADE-THROUGH RULE THAT WOULD BE DIFFICULT TO ENFORCE, WE SUGGEST LAUNCHING A PILOT PROGRAM SIMILAR TO THE ETF DE MINIMIS EXEMPTION FROM THE TRADE THROUGH FOR A CROSS SECTION OF LISTED STOCKS, WITH NO TRADE-THROUGH RESTRICTIONS. THE COMMISSION COULD THEN MONITOR AND MEASURE THE RESULTS OF FREE COMPETITIVE FORCES.[2]

MARKET DATA THE FINANCIAL SERVICES COMMITTEE HAS LONG HELD THAT MARKET DATA IS THE "OXYGEN" OF THE MARKETS. ENSURING THAT MARKET DATA IS AVAILABLE IN A FASHION WHERE IT IS BOTH AFFORDABLE TO RETAIL INVESTORS AND WHERE MARKET PARTICIPANTS HAVE THE WIDEST POSSIBLE LATITUDE TO ADD VALUE TO THAT DATA ARE HIGH PRIORITIES.

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2 See Hendershott and Jones, "Trade-Through Prohibitions and Market Quality", unpublished working paper (April 8, 2004) at p.8, available at http://faculty.haas.berkeley.edu/hender/ ("There is no evidence that market quality worsens when the trade-through rule is relaxed. In fact, overall effective spreads actually fall for all three ETFs, and the fall is statistically significant for DIA and QQQ.")

The Commission would be able to monitor the execution quality from filings under Rule 11Ac1-5.

BEFORE THE 1970S, NO STATUTE OR RULE REQUIRED SELF-REGULATORY ORGANIZATIONS (SROS) TO DISSEMINATE MARKET INFORMATION TO THE PUBLIC OR TO CONSOLIDATE INFORMATION WITH INFORMATION FROM OTHER MARKET CENTERS. INDEED, THE NYSE, WHICH OPERATED THE LARGEST STOCK MARKET, CLAIMED AN OWNERSHIP INTEREST IN MARKET DATA, SEVERELY RESTRICTING ACCESS TO MARKET INFORMATION. MARKETS AND INVESTORS SUFFERED FROM THIS LACK OF TRANSPARENCY.

AT THE URGING OF THE SEC, CONGRESS RESPONDED BY ENACTING THE SECURITIES ACTS AMENDMENTS OF 1975. THESE AMENDMENTS EMPOWERED THE SEC TO FACILITATE THE CREATION OF A NATIONAL MARKET SYSTEM FOR SECURITIES, WITH MARKET PARTICIPANTS REQUIRED TO PROVIDE — IMMEDIATELY AND WITHOUT COMPENSATION — INFORMATION FOR EACH SECURITY THAT WOULD THEN BE CONSOLIDATED INTO A SINGLE STREAM OF INFORMATION.

AT THE TIME, CONGRESS CLEARLY RECOGNIZED THE DANGERS OF DATA-PROCESSING MONOPOLIES. THE REPORT ACCOMPANYING THE 1975 AMENDMENTS EXPRESSLY WARNS THAT:

> PROVISION MUST BE MADE TO INSURE THAT THIS CENTRAL PROCESSOR IS NOT UNDER THE CONTROL OR DOMINION OF ANY

PARTICULAR MARKET CENTER. ANY EXCLUSIVE PROCESSOR IS, IN EFFECT, A PUBLIC UTILITY, AND THUS IT MUST FUNCTION IN A MANNER WHICH IS ABSOLUTELY NEUTRAL WITH RESPECT TO ALL MARKET CENTERS, ALL MARKET MAKERS, AND ALL PRIVATE FIRMS.[3]

EVEN AS NOT-FOR-PROFIT ENTITIES, SROS HISTORICALLY HAVE EXPLOITED THE OPPORTUNITY TO SUBSIDIZE OTHER COSTS (E.G., EXECUTIVE COMPENSATION, COST OF MARKET OPERATION, MARKET REGULATION, MARKET SURVEILLANCE, MEMBER REGULATION) THROUGH THEIR GOVERNMENT-SPONSORED MONOPOLY ON MARKET INFORMATION FEES. WHILE THIS SUBSIDY IS TROUBLING ENOUGH, THE INCENTIVE TO EXPLOIT THIS MONOPOLY POSITION WILL BE EVEN STRONGER AS SROS CONTEMPLATE FOR-PROFIT FUTURES AND NEW LINES OF BUSINESS.

IN ITS 1999 CONCEPT RELEASE ON MARKET DATA, THE COMMISSION NOTED THAT MARKET DATA SHOULD BE FOR THE BENEFIT OF THE INVESTING PUBLIC. INDEED, MARKET DATA ORIGINATES WITH SPECIALISTS, MARKET MAKERS, BROKER-DEALERS AND INVESTORS. THE EXCHANGES AND THE NASDAQ MARKETPLACE ARE NOT THE SOURCES OF MARKET DATA, BUT RATHER THE FACILITIES THROUGH WHICH MARKET

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3 Report of the Senate Comm. on Banking, Housing, and Urban Affairs to accompany s.249, S. Rep. no. 94-75, 94th Cong., 1st Sess. 11 (1975).

DATA ARE COLLECTED AND DISSEMINATED. IN THAT 1999 RELEASE, THE SEC PROPOSED A COST-BASED LIMIT TO MARKET DATA REVENUES. WE BELIEVE THE SEC WAS CLOSER TO THE MARK IN 1999 WHEN IT PROPOSED MAKING MARKET DATA REVENUES COST-BASED, THAN IN ITS REGULATION NMS PROPOSAL, WHICH PROPOSES A NEW FORMULA FOR DISPENSING MARKET DATA REVENUE WITHOUT ADDRESSING THE UNDERLYING QUESTION OF HOW TO EFFECTIVELY REGULATE THIS MONOPOLY FUNCTION.

EVERY INVESTOR WHO BUYS AND SELLS STOCKS HAS A LEGITIMATE CLAIM TO THE OWNERSHIP OF THE DATA AND LIQUIDITY HE OR SHE PROVIDES TO MARKET CENTERS. FUNNELING EXCLUSIVE LIQUIDITY INFORMATION TO EXCHANGE MEMBERS AND FUNNELING MARKET DATA REVENUES TO EXCHANGES AND NASDAQ AND NOT TO INVESTORS SHIFTS THE REWARDS FROM THOSE WHO TRADE TO THOSE WHO FACILITATE TRADING.

UNDER THE CURRENT SYSTEM, MARKET DATA REVENUES PROVIDE SROS WITH FUNDS TO COMPETE WITH OTHER EXECUTION CENTERS. FOR EXAMPLE, ARCHIPELAGO HOLDINGS ("ARCHIPELAGO") RECENTLY FILED AN IPO REGISTRATION STATEMENT WITH THE COMMISSION IN WHICH IT REPORTED SOME $23 MILLION FOR 2003 REVENUE FROM MARKET DATA. THIS WAS NET OF $7.5 MILLION PAID TO THE PACIFIC STOCK EXCHANGE

FOR MARKET REGULATION SERVICES. ARCHIPELAGO FURTHER STATED THAT IT USES THIS REVENUE TO COMPETE WITH NASDAQ, THE NYSE AND ECNS, SUCH AS BLOOMBERG TRADEBOOK. THAT IS, THE MARKET DATA REVENUES ARCHIPELAGO RECEIVES AS AN EXCHANGE ARE, IN EFFECT, GOVERNMENT-SANCTIONED SUBSIDIES THAT CONFER AN UNFAIR COMPETITIVE ADVANTAGE ON ARCHIPELAGO AND SIMILARLY SITUATED SROS.

THE COMMISSION'S PROPOSAL WITH RESPECT TO MARKET DATA WOULD PERPETUATE THE EXCLUSIVE AND LUCRATIVE FRANCHISE SROS ENJOY OVER THE COLLECTION, DISSEMINATION AND SALE OF MARKET DATA. AS SUCH, THE COMMISSION HAS A STATUTORY DUTY TO ENGAGE IN RATEMAKING PROCEEDINGS WITH RESPECT TO THESE GOVERNMENT-SANCTIONED MONOPOLIES. IT IS TRULY NECESSARY FOR THE COMMISSION TO ASSESS THE FAIRNESS AND REASONABLENESS OF THE NYSE AND NASDAQ MARKET DATA FEES — FEES FOR WHAT ARE ESSENTIALLY MONOPOLY SERVICES. IF THOSE FEES ARE EXCESSIVE OR POORLY STRUCTURED, THEY MAY HAVE CREATED MARKET DISTORTIONS AND ALLOWED THOSE ENTITIES TO EXTRACT MONOPOLY RENTS FROM THE INVESTING PUBLIC FOR OVER A GENERATION.

SIGNIFICANTLY, NASDAQ'S ROBERT GREIFELD CANDIDLY ADMITTED AT THE COMMISSION'S REGULATION NMS HEARING ON APRIL 21 THAT THE EXISTING DATA FEES ARE TOO HIGH:

> [W]E BELIEVE THE GOVERNMENT SHOULD ONLY BE INVOLVED WHERE THE GOVERNMENT MUST BE INVOLVED. SO WE MUST LIMIT THE MONOPOLY TO THE DATA THAT IS PART OF THE PUBLIC GOOD, AND PROVIDE IT AT A LOW COST . . .
>
> WITH THE CURRENT STRUCTURE . . . DATA IS NOT PROVIDED AT A LOW ENOUGH COST AND IT DOES CREATE . . . UNINTENDED RESULTS AND DISTORTIONS IN OUR MARKET. THE MARKET CENTERS TODAY ARE THE BENEFICIARIES OF THAT EXCESSIVE RENT . . . .[4]

IN ADDITION TO QUESTIONS REGARDING WHO OWNS MARKET DATA AND WHO SHARES IN THE REVENUE AND THE SIZE OF DATA FEES, WE BELIEVE THE COMMISSION OUGHT ALSO TO REVISIT HOW MUCH MARKET DATA SHOULD BE MADE AVAILABLE TO INVESTORS. HERE, DECIMALIZATION HAS BEEN THE WATERSHED EVENT. GOING TO DECIMAL TRADING HAS BEEN A BOON TO RETAIL INVESTORS. IT HAS BEEN ACCOMPANIED, HOWEVER, BY DRASTICALLY DIMINISHED DEPTH OF

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4 Statement by Robert Greifeld, President and CEO of The Nasdaq Stock Market, Inc. at SEC Hearings on Regulation NMS (April 21, 2004), available at http://www.sec.gov/spotlight/regnms/nmstrans042104.txt (pp. 223-4).

DISPLAYED AND ACCESSIBLE LIQUIDITY. WITH A HUNDRED PRICE POINTS TO THE DOLLAR, INSTEAD OF EIGHT OR SIXTEEN, THE INFORMATIONAL VALUE AND AVAILABLE LIQUIDITY AT THE BEST BID AND OFFER HAVE DECLINED SUBSTANTIALLY.

PARTICULARLY GIVEN THE EFFECTS OF DECIMALIZATION, ALLOWING THE NYSE, FOR EXAMPLE, TO HOLD MARKET DATA AND LIQUIDITY BACK FOR THE BENEFIT OF ITS FLOOR MEMBERS IS AGAINST THE PUBLIC INTEREST. THE COMMISSION HAS HEARD COMPLAINTS BEFORE ABOUT THE NYSE AUCTION PROCEDURES THAT ALLOW HIDDEN AGENCY AND SPECIALIST ORDERS HELD IN THE CROWD TO HAVE PRICE-TIME PRIORITY OVER ORDERS DISPLAYED VIA THE PUBLIC QUOTATION SYSTEM. THESE FLOOR PROCEDURES GIVE NYSE MEMBERS AN UNFAIR OPPORTUNITY TO JUMP AHEAD OF, OR TO "PENNY", PUBLICLY DISPLAYED LIMIT ORDERS AND TO "GO ALONG", OR HITCH A RIDE, ON LARGE INSTITUTIONAL MARKETABLE ORDERS.

IN RESPONSE TO DECIMALIZATION, THE COMMISSION SHOULD RESTORE LOST TRANSPARENCY AND LIQUIDITY BY MANDATING GREATER REAL-TIME DISCLOSURE BY MARKET CENTERS OF LIQUIDITY AT LEAST FIVE CENTS ABOVE AND BELOW THE BEST PRICES. GIVEN THE INCENTIVES OF A SLOW MARKET SUCH AS THE NYSE TO HIDE QUOTATION INFORMATION AND TO BLOCK DIRECT ACCESS TO LIQUIDITY, THE REAL-

TIME DISCLOSURE OF LIQUIDITY SHOULD NOT BE LEFT TO "MARKET FORCES", WHICH CAN WORK IN THIS INSTANCE ONLY IF DISCLOSURE IS MANDATED. THIS WOULD RESTORE THE TRANSPARENCY AND DIRECT ACCESS INVESTORS HAD BEFORE THE ADVENT OF DECIMALIZATION.

ACCESS FEES. I'D LIKE TO TOUCH BRIEFLY ON ONE OTHER ASPECT OF REGULATION NMS, NAMELY ACCESS FEES. BLOOMBERG HAS LONG BELIEVED THAT ACCESS FEES SHOULD BE ABOLISHED FOR ALL SECURITIES AND ALL MARKETS. WHILE WE APPLAUD THE SEC'S EFFORTS TO REDUCE ACCESS FEES, WE ARE CONCERNED THAT THE COMPLEXITIES INHERENT IN CURTAILING THESE FEES WITHOUT ELIMINATING THEM ARE LIKELY TO CREATE AN UNEVEN PLAYING FIELD.

WE ARE ALSO CONCERNED THAT THE PROPOSED LIMITATIONS ON ACCESS FEES IN REGULATION NMS APPLY ONLY TO THE TOP OF THE FILE. I.E., TO THE BEST BID AND OFFER. WHILE ECNS' FEES WILL BE LIMITED BY THE AMOUNT PERMITTED UNDER THEIR CURRENT NO-ACTION LETTERS, BY CONTRAST, THE COMMISSION'S ACCESS FEE PROPOSAL DOES NOT APPLY TO ACCESS FEES FOR QUOTES BEYOND THE NBBO.

WE REMAIN CONCERNED THAT THE PROMISE OF DECIMILIZATION WILL BE FRUSTRATED IF THE NYSE IS GRANTED GREATER RIGHTS TO DATA THAT REPRESENTS TRADING INTEREST IN A DECIMILZED

ENVIRONMENT — IN THE CONTEXT OF MARKET DATA FEES, ACCESS FEES, OR CONTROL OF USES OF INFORMATION — THAN THE NYSE ENJOYED WHEN TRADING INTEREST WAS EXPRESSED IN EIGHTHS AND SIXTEENTHS.

CONCLUSION. THIS COMMITTEE HAS BEEN IN THE FOREFRONT OF THE MARKET STRUCTURE DEBATE-AND I APPRECIATE THE OPPORTUNITY TO DISCUSS HOW THESE SEEMINGLY ABSTRACT ISSUES HAVE A CONCRETE REAL-WORLD IMPACT ON INVESTORS.

REGULATION NMS IS A BOLD STEP TO BRING OUR MARKETS INTO THE 21ST CENTURY. THE SEC IS TO BE COMMENDED FOR PROMPTING WHAT HAS ALREADY BEEN A PRODUCTIVE DEBATE. IN AN EFFORT TO ACCOMMODATE A DIVERSE ARRAY OF INTERESTS, HOWEVER, WE BELIEVE THERE IS A RISK THAT REGULATION NMS MAY RE-SHUFFLE, RATHER THAN ELIMINATE, CURRENT IMPEDIMENTS TO MARKET EFFICIENCY.

ELIMINATION OF THE TRADE-THROUGH RULE, ELIMINATION OF ACCESS FEES, AND GREATER EFFORTS TO ENHANCE THE TRANSPARENCY AND CONTROL THE COSTS OF MARKET DATA WOULD HELP PROMOTE A 21ST CENTURY EQUITY MARKET THAT BEST SERVES INVESTORS.

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Testimony of John Giesea
Security Traders Association

Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Financial Services Committee

Hearing on
"The SEC Proposal on Market Structure: How will Investors Fare?"

Tuesday, May 18, 2004

Good afternoon Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee. I am John Giesea, President and Chief Executive Officer of the Security Traders Association ("STA"). Thank you for the opportunity to testify on behalf of the STA to discuss the important issues relating to the structure of the US equities markets, specifically as they relate to the Securities and Exchange Commission's ("SEC") proposed Regulation NMS.

The STA is composed of approximately 6,000 individuals engaged in the purchase, sale and trading of securities for individuals and institutions.

Proposed changes to market structure will ultimately impact investors and the capital formation process. That is why these deliberations are so important. But as we consider such changes, we must also realize that the needs of all investors are not always the same.

My testimony will highlight the major points of which the STA has achieved consensus on proposed Regulation NMS. The STA has consistently called for SEC action to address several structural anomalies, so it is encouraged by the release of proposed Regulation NMS. The STA's White Paper[1] released last year provided three major recommendations that if implemented, would make the markets more efficient and serve to benefit investors:

1. Improve intermarket linkages and trading rules.
2. Require consistent rules across markets.
3. Eliminate ECN access fees.

Proposed Regulation NMS

The STA is currently in the process of completing its formal comment on proposed Regulation NMS. The process has involved input from more than 60 traders, including those from the buy-side and sell-side, to undertake a very comprehensive review. Since the STA's traders represent all market segments, the organization provides a unique perspective of the impacts of market structure proposals.

[1] *Fulfilling the Promise of the National Market System: STA's Perspective on US Market Structure*, August 2003.

Proposed Regulation NMS includes four new rules or changes to existing rules that address the following issues:

- A uniform rule for the prevention of trade-through across all market centers, subject to certain exceptions.
- A uniform rule that would permit all market participants to access other markets on a non-discriminatory basis with a *de minimis* charge of $0.001 per share for such access.
- A ban on sub-penny quotations.
- A modification of the formula used for allocating market data revenues.

I will highlight the four proposals in Regulation NMS and the major points where the STA has largely reached consensus on these issues.

Trade-Through Rule

Since the publication of our White Paper, the STA has taken the position that a fully linked market with automatic execution will substantially diminish the need for a trade-through rule.

The SEC's proposal would create a uniform trade-through rule, with exceptions for: 1) an opt-out on an order-by-order basis, and 2) an automated market executing orders without regard to a better price in a non-automated market. The automated market would be able to trade through slower markets by a *de minimis* amount, varying from $0.01 to $0.05, depending on the price of the stock.

STA suggests one way to address the trade-through proposal would be to execute it in a phased approach, thereby significantly reducing the potential unintended consequences. Each phase would be implemented after a comment period provides opportunity for review. The first phase should clearly define "automated" and "non-automated" markets. Step two would oversee the creation of linkages to ensure true connectivity and access among the markets. Halfway measures are not sufficient if there is not an accompanying high degree of connectivity. Phase three would be a reexamination of the need for a trade-through rule, as such a rule may be impossible to enforce as well as unnecessary given the competitive forces driving best execution standards. The end result of this phase-in approach would be a major step toward the envisioned National Market System and beneficial for all market participants and investors.

Although the STA views the proposal as a very positive approach to drive markets toward more automation, and economic and efficient access, I make a few points for consideration.

The proposal would extend the trade-through rule to the Nasdaq market. We question why, when there have not been problems regarding price protection, the rule should be imposed on the Nasdaq market. Adoption of an intermarket trade through rule should be made following

implementation of the steps discussed above. It would be incorrect to impose this rule at the onset.

Although there may be some practical and other drawbacks to an opt-out, we would support an opt-out exception on an interim basis for the purpose of driving greater automation in, or access to, markets. However, if automatic execution and efficient and economic access to quotes were achieved, an opt-out provision would become unnecessary. Therefore, an opt-out exemption should be specifically designed as an interim tool to achieve near-term execution objectives necessary in today's market conditions, while continuing to provide an incentive for change.

A key determination is the definition of an automated market. STA believes that a market must provide for automatic execution coupled with immediate refresh capability. Less stringent criteria would neutralize the gains sought in an updated national market system.

The varying *de minimis* amounts at which a trade-through can occur, depending on the price of the stock, are overly complex. Instead a flat $0.03 increment rather than the proposed tiered structure would be less burdensome and expensive to administer.

Access Fees and Locked and Crossed Markets

The Commission has correctly identified access fees as a critical component of any discussion regarding best execution. The SEC's proposal to cap access fees at $0.001 per share is a very positive step toward reducing the current problems in the marketplace; however, we continue to believe the preferred action is complete elimination.

The STA has long held that access fees, since they are not included in the quotes of an ECN's system, complicate best execution obligations and undermine transparency of prices. Broker-dealers that do not subscribe to ECNs may sometimes be required to interact with a quote on an ECN's system if it is the best bid or offer ("BBO"). If a broker-dealer accesses the ECN's quote in order to fulfill its best execution obligations, then it is charged an access fee even if it is not aware of the existence or amount of the fee. Access fees also create market inefficiencies by imposing economic disincentives to seeking out the best price and by creating incentives to lock and cross markets.

Rather than allow all markets, in addition to ECNs, to charge access fees as the SEC proposes, the STA believes simply eliminating such fees would provide more benefits to investors. However, the SEC's proposed *de minimis* cap of $0.001 per share will create more consistency of such fees and seems an equitable approach.

The SEC's proposal appropriately calls upon markets to create and enforce rules eliminating locked and crossed markets. The best way to eliminate the economic incentives causing locked and crossed markets would be to simply ban access fees. The STA strongly supports a uniform intermarket rule that assists in preventing locked and crossed markets. Locked and crossed markets impact the execution of investors' trades, causing delays in getting customer orders filled. Such market conditions may actually result in a trade being executed at an unfavorable price due to the market changing after the market is unlocked.

Sub-penny Quotes

Sub-penny quotations create a number of problems in the market, including a decrease in market depth at the BBO and the facilitation of stepping ahead of limit orders by some market participants. A move to sub-penny quoting would result in a decrease in the amount of liquidity at each price point, which does not benefit the investor. Proposed Regulation NMS cites an SEC staff study that finds sub-penny trades cluster at the $0.001 and $0.009 price points, suggesting stepping ahead behavior. The SEC's proposal to ban sub-penny quoting, which is strongly endorsed by the STA, recognizes such troubling results of sub-penny quoting.

I want to intentionally draw a distinction between sub-penny quoting and sub-penny trading. There are certain instances where sub-penny trading, such as volume weighted average pricing (VWAP) and other averaging mechanisms, are used to facilitate certain executions. Such instances actually increase efficiencies and ultimately benefit investors.

Of all issues embedded in Regulation NMS, this is one that appears to have gained near universal acceptance. STA, since 2001, has actively supported the elimination of sub-penny quotations.

Market Data

The STA is not is a position to comment on the precise formula to be used for the distribution of market data revenues. We are, however, supportive of market data allocation proposals that lead to rewarding quality quotes, and at the same time eliminate the print factory and other practices designed only to game the revenue stream.

Liquidity Providers

I also note the importance of liquidity providers to the capital formation process and the efficient functioning of the markets. Just as not all investors are alike, not all stocks trade alike. Liquidity providers such as specialists and market makers are especially important for the trading of less active stocks where natural buyers and sellers are not always available at a specific price point. A lack of liquidity in such stocks diminishes the ability of those companies to raise capital, thus adversely impacting the US economy and ultimately, job creation for these smaller businesses.

The trend in rulemaking has been to encourage the matching of buyers and sellers without an intermediary. There would likely be consensus that some highly liquid stocks such as Intel (Nasdaq: INTC) do not, under normal circumstances, require a liquidity provider to facilitate the execution of trades. However, the need for specialists and market makers becomes ever more important in stress situations, whether they be stock specific or general market conditions. Where liquidity providers add significant value is in the trading of less active stocks where natural buyers and sellers are not always immediately available.

Conclusion

I thank the Members of the Subcommittee for your continued interest in ensuring that the US markets are efficient and liquid. Such characteristics are important to a robust capital formation process, benefit the US economy, and ultimately benefit all investors. For it is the

investor who drives the markets; therefore, the investor should be the focus of any changes made to the structure of our markets.

The STA views the National Market System principles established in the Securities Exchange Act of 1934, namely the maintenance of efficient, competitive and fair markets, as both a measure and a goal. The SEC's proposed Regulation NMS is a step towards the goal of a more national market system. However, such a system could be further facilitated by a connectivity-based approach, or one in which the various markets are connected and quotes between such markets can be quickly and efficiently accessed. Such an approach will encourage the facilitation of automatic execution of orders and best serve the interests of investors.

Testimony of Larry Leibowitz, Executive Vice President and Co-CEO of Schwab Soundview Capital Markets Before the U.S. House of Representatives' Financial Services Subcommittee On Capital Markets, Insurance and Government Sponsored Enterprises May 18, 2004

Chairman Baker, Ranking Member Kanjorski, distinguished members of the Committee, my name is Larry Leibowitz. I'm Executive Vice President and Co-CEO of Schwab Soundview Capital Markets, the institutional trading, research, and retail execution arm of The Charles Schwab Corporation. Thank you for the opportunity to speak today on the vital market structure reforms proposed by the Securities and Exchange Commission.

Schwab Soundview Capital Markets, as the largest Nasdaq market maker by volume, and Charles Schwab & Company, with its millions of retail customers, believe that the time is ripe for modernization of our national market system. We process millions of orders a day and these orders are directly impacted by the conflict between modern technology and the antiquated rules from an era marked by human interaction when trading securities. These rules primary serve to insulate outdated and inefficient manual markets from competition, and actually harm, rather than protect, investors.

For too long competition has been stifled in the market for NYSE and Amex-listed securities. Given the very limited time available, I will focus my prepared comments on the two main culprits—the so-called "Trade Through Rule" and the current market data system.

Trade Through Rule

The Intermarket Trading System ("ITS") Trade Through Rule purportedly protects investors from inferior prices, but has actually insulated the NYSE and its specialist system from competition and protected its privileged position. Given the NYSE's role in the creation of the original Trade Through Rule, the rule has worked as it intended - to protect its monopoly profits.

Being forced to route orders to manual markets for execution lowers efficiency and, in some cases, actually undermines a broker's duty of best execution. A better alternative is available. When securities are traded in an automated environment without a Trade Through Rule, as they are in Nasdaq today, investors obtain greater order protection, faster executions and better prices. Investors are protected by the broker-dealer's overriding obligation to provide best execution to customers.

In addition, when a market is efficient, you don't need a rule prohibiting trade throughs. They simply do not happen. And you don't have to take my word for it. The Commission's own order handling statistics, the so called 11Ac1-5 numbers, prove that

automatic markets that are free of trade through restrictions provide investors with better results: better prices, faster executions, and fewer canceled orders.

The appropriate reform is obvious. Eliminate the ITS Trade Through Rule and allow competition to flourish as it does in the Nasdaq market. Short of full and outright repeal, Schwab proposes alternatively that the Commission first act to improve the interaction among markets trading listed securities. Then, after appropriate analysis of listed trading data, determine whether to eliminate the Trade Through Rule in its entirely.

Specifically, we believe the Commission should take the following steps:

- Investors should be given the choice to ignore slow and inefficient market centers. Therefore, we urge the Commission to support a fast market/slow market exception to the ITS Trade Through Rule. Such an exception will induce markets to implement automatic execution and automatic quote updating, thereby benefiting investors through the ensuing efficiency.

- Second, the Commission should require broker-dealers to disclose the percentage of orders executed outside the NBBO. Schwab believes that more detail regarding a fast market trading through another fast market will provide investors with the data necessary to determine the execution quality of their orders.

- Finally, Schwab believes that customers should be allowed to decide for themselves what constitutes best execution. Therefore, Schwab urges the Commission to amend the ITS Plan to include an opt-out provision so that investors, *rather than one-size-fits-all rules*, can determine how best to execute their orders.

Market Data

With regard to market data, Schwab believes that the current SEC proposal simply misses the real problem. Rather than treat the symptoms, the Commission should focus on reforming a monopoly based system that wildly increases the cost to investors for vital trading information.

Investors have heard lots of different stories about why market data is so expensive. We heard just two weeks ago that it costs the NYSE $488 million per year to generate market data. Strange given that, *as the Commission described in its reform proposal*, last year the Plan Networks made $424 million in revenue and incurred only $38 million in expenses. That's a monopoly mark-up of 1,000 percent. Further, Nasdaq, operator of one of the data networks, recently stated that it believes it can cut its monopoly data prices by 75% and still provide a sufficient return to its shareholders. Clearly, there is excess market data money sloshing around the exchanges, which manifests itself in everything from tape shredding, to market data rebates, to exorbitant pay packages for executives. This excess revenue is extracted from average investors who pay inflated charges to the exchange to see their own limit orders displayed.

The government-created market data cartels should be asked to justify the cost. Until there is transparency in cost and governance, the market data cartels will never change and investors will continue to subsidize markets. Schwab believes that markets should fund their regulatory and operational functions directly and transparently themselves, rather than indirectly through opaque market data charges to investors.

Schwab has three recommendations:

- First, price information relating to the NBBO based on its cost, thereby facilitating widespread availability.
- Second, simplify and standardize network accounting so that the expenses relating to market data consolidation are transparent, available to individual investors and independently audited.
- Finally, require public representation on network operating committees. A toothless advisory committee is a status quo proposal. Today, everyone acknowledges the need for independent members on the boards of public companies, mutual funds, and even SROs. Governance of market data should be no different.

Conclusion

In closing, Schwab commends this Committee for exercising its oversight role and examining these important issues. To sum up, Schwab hopes the SEC repeals the Trade Through Rule, or at a minimum institutes meaningful reforms, to unleash a wave of modernization in the listed market. Further, we urge the Commission to reexamine its market data proposal to end monopoly profits and ensure that all investors have access, at a reasonable price, to the most basic trading information.

Thank you again for the opportunity to testify today. I look forward to answering any questions you may have.

Testimony of Dan McCabe, Bear Hunter

House Financial Services Committee

Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee

May 18, 2004

Good Afternoon. Thank you. Mr. Chairman, for the opportunity to testify in front of the subcommittee.

A little bit of background first for the committee. I am the CEO of Bear Hunter Structured Products LLC. We are liquidity providers in derivative products, such as options, futures and exchange traded funds.

Bear Hunter is a wholly-owned subsidiary of Bear Wagner, which is one of the five major specialist firms on Wall Street. We represent more than 350 listed companies, including such household names as Pepsi, Aetna, Alcoa, Xerox and Kimberly-Clark, to name a few. Bear Wagner is a member of the NYSE, Amex, CME, ISE, CBOT and CBOE and actively trades in all venues.

Mr. Chairman, I am worried about the impact of the proposed changes, not only on the individual investor, but also our listed companies and the New

York Stock Exchange itself. I am deeply concerned because the thrust of these new regulations is focused on speed only; and speed will ferment both price and temporal volatility in the market, scaring off individual investors, destroying confidence and, over time, driving down the market cap of our clients. Since the introduction of decimal pricing, the markets have already experienced 126 percent growth in program trading, to the detriment of the individual investor.

Allow me to elaborate. Excessive volatility serves no one but professional investors. Over the last two years, 39 NASDAQ listed companies have chosen to move to the New York Stock Exchange. They have, on average, experienced a 50 percent reduction in inter-day volatility. They made this choice to facilitate the raising of capital. After five years of market softness and financial scandals, is more volatility really going to help lure the individual investor back into the market or are we creating a market dominated by professional program traders?

What is driving the focus on speed? Certainly, not the majority of investors in this country. When AARP recently surveyed nearly 2,000 of its members, two-thirds of them said price is the top priority when engaging in a market transaction. The second consideration was the brokerage fees. Speed barely registered in the survey.

Chris Hansen, of the AARP, representing that organization's 35 million members, said, "The SEC needs to proceed carefully in proposing changes

that could undermine the ability of individual investors to get the best price for the lowest transaction cost."

I couldn't agree more.

Some of our competitors say everything should be done in nanoseconds, same second executions should be the driving force in markets. I don't think we want the NYSE looking like an ECN, where stocks flicker excessively while attempting to discover price, nor do I understand why the markets with excessive volatility will be rewarded through REG NMS.

In addition, I think the logical outcome of these proposed rules will be dramatic fragmentation and internalization, where sophisticated investors opt out and the common person is left behind. The solution is not to develop a bifurcated market for insiders and small investors, but to instead link all the markets together. Define a reasonable time frame, say five or six seconds, where orders must be executed or else face a penalty. Mandate that all parties compete on price.

Today, many people have the vision of the NYSE from a bygone era, with brokers wandering the floor, hand writing orders on tiny scraps of paper. Today, over 85 percent of the time, orders are executed in less than ten seconds. Specialists provide additional liquidity roughly 15 percent of the time to smooth out short-term volatility, which helps stabilize the market for both investors and listing companies.

I think the real motive behind much of this debate has nothing to do with the individual consumer, but rather an attempt by failing business models to gain an advantage through regulations.

Here's a recent quote from Steve Pearlstein of the Washington Post, "The fact that these parties are trying to divert more trading away from the exchange raises suspicions that their lobbying campaign may have less to do with protecting the interests of the investing public than with gaining competitive advantage or taking over the market making function themselves."

Again, let's look at the NASDAQ. Five years ago, the exchange handled more than 90 percent of the market for its own stocks. Today, it is less than 20 percent. Currently, the NASDAQ and all of its electronic competitors go at the same speed. Why have they lost market share? Simply because of practices like payment for order-flow or the sharing of tape revenue. Those practices must be disbanded for the mere health of the market.

Individual investors buy and sell based on price. When millions of investors get home tonight and check on their 401(k) programs, they will carefully watch the prices of their stocks and mutual funds. I can't believe a single one of them will wonder whether their shares traded in five seconds or eight. Moreover, most will have no knowledge of which

exchange traded their security or under what rules they were traded.

Can the NYSE move faster? Yes, and it should. But price and transparency are equally important principles this committee and the SEC must not abandon.

Thank you for your time and consideration.

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before the
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

United States House of Representatives

May 18, 2004

The SEC Proposal on Market Structure

Thank you Chairman Baker, Ranking Member Kanjorski, and members of the Committee for the opportunity to present to you this morning my views on reform of US market-structure regulation.

Although the SEC's proposed "Regulation NMS" covers a wide range of important issues related to market linkages, access fees, and market data, I will confine my brief, prepared remarks to the specific matter of the "trade-through rule," changes in which have the greatest potential to improve the ability of our securities markets to service investors.

Although the idea of having a simple, market-wide rule to ensure that investors always have access to the "best price" is an attractive one, in practice the trade-through rule has operated to force investor orders down to the floor of the New York Stock Exchange, irrespective of investors' wishes. The rule therefore operates to discourage free and open competition among marketplaces and market structures; the type of free and open competition which has in Europe produced a new global standard for best-practice both in trading technology and exchange governance. The trade-through rule should therefore be eliminated, as it serves neither to protect investors nor to encourage vital innovation in our marketplace.

Those who support the maintenance of some form of trade-through rule, most notably the New York Stock Exchange, have raised five main arguments in its defense. The most effective way to illustrate why the rule is undesirable is to address each of these directly.

1. "Why should *speed* be more important than *price*?"

According to this view, the whole debate is about whether traders should be allowed to sacrifice best-price in the pursuit of speed. But the notion that investors would ever sacrifice price for "speed" is nonsensical. In the marketplace, it is *always* about price. It is about the *price for the number of shares the trader wants to trade*, not just the 100 shares advertised on the floor of the NYSE, and it is about the *price that is really there when the trader wants to trade*. Statistics from

competing marketplaces about fill rates, response times, and the like make very nice input into a trader's decision, but they are not substitutes for a decision.

2. ". . . but the rule is necessary to protect market orders!"

The normal fiduciary principle says that "the agent must act in the customer's interests." But the trade-through rule says that "the agent must *ignore* the customer's interests." In other words, to eliminate any possibility that a broker may abuse his discretion, regulators should forbid not only his discretion but his *customer's*. This cannot be sensible.

To illustrate, an investor may wish to buy 10,000 shares at $20 a share, done at a key stroke on market *x*. The trade-through rule, however, would oblige that investor instead to buy 100 shares at $19.99 at the New York Stock Exchange and then submit to a floor auction there, so that Exchange members on the floor may profit from knowledge of his desire to buy many more shares.

Tellingly, the same people who insist that brokers will abuse discretion, or that their customers should not be entitled to it, will defend to the death the right of *specialists* to use discretion. This view, curiously, is entirely unburdened by knowledge of the $241.8 million in fines paid by five of the seven NYSE specialist firms for improper discretionary trading.

3. ". . . but the rule is necessary to protect limit orders!"

According to this argument, it is not the market orders that have to be protected, but rather 100-share limit orders. But this is a strange principle for the NYSE to defend, given that the floor could not even *exist* were it not for the ability of specialists and floor brokers to trade in front of limit orders. Indeed, the most frequent complaint of institutional investors about trading on the floor is precisely the fact that limit orders are revealed to the crowd, who are then allowed to use that information to trade in front of them.

In a marketplace, Mr. Chairman, it takes *two* to trade. The fellow who puts down a limit order in market *x* has no moral standing over the gal who sees a better package deal in market *y*. Appeals to "fairness" favor neither one over the other.

4. " . . . but if limit orders are traded through, no one will place them!"

If limit orders are traded through on market *x*, they just won't be placed *on market x*. They will move to market *y*, where they won't get traded through.

5. ". . . but a fair compromise is to have a trade-through rule among 'fast' markets."

The NYSE has stated repeatedly that in the "fast" Exchange of the future there *must* be a role for the floor auction. To be clear, this means that the NYSE will only be "fast" for as few shares as the SEC will let them get away with.

So to go back to the example of an investor wanting to buy 10,000 shares available on market *x* at $20 a share, if the NYSE is designated a "fast" market it means only that the NYSE might sell him a fast few hundred shares at $19.99, but then – just like old times, Mr. Chairman – the Exchange will force him into a floor auction.

More fundamentally, do we really want the government to be in the business of determining which markets are "fast" enough for all investors, now and in the future, and doling out protection from competition on that basis? My judgment is that we do not.

To conclude, I do not believe that any of these arguments for a trade-through rule are compelling. Moreover, the rule is not even enforced at present against its leading supporter and only systematic violator, the New York Stock Exchange, which trades through other markets hundreds, even thousands of times a day. Since the SEC is silent on the question of how the rule will actually be enforced in the future, it must be assumed that if perpetuated it will continue to operate solely to force investors to trade on the New York Stock Exchange even if they desire to do otherwise.

The SEC should, of course, be concerned to see that intermediaries do not abuse their discretion in handling investor orders. But given that the focus of recent SEC disciplinary action has been improper discretionary trading by *specialists*, it cannot be in the interests of investors to oblige them to trade with specialists if they do not wish to. After all, the SEC emphasizes in its proposal

that a trade-through rule "in no way alters or lessens a broker-dealer's duty to achieve best execution for its customers' orders." If this is truly the case, Mr. Chairman, then a trade-through rule is neither necessary nor desirable.

I thank you again for the opportunity to testify this morning, and I look forward to assisting your deliberations in any way possible.

Testimony before the

Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises

The SEC Proposal on Market Structure: How will Investors Fare?

Peter J. Wallison
Resident Fellow, AEI

May 18, 2004

Mr. Chairman and members of the subcommittee:

I am pleased to have this opportunity to offer my views on the SEC's proposed Regulation NMS and, if implemented in current form, its likely effects on investors.

Regulation NMS is a complex proposal, with elements that address different aspects of the national market system. In my testimony, I will discuss only the basic question of market structure, which is implicated by the Regulation's proposed changes in the applicability of the so-called trade-through rule.

The US securities market today consists of two entirely different structures—a centralized market for the trading of New York Stock Exchange listed securities, and a set of competing market centers for the trading of Nasdaq securities. One of these models—and only one—is likely to be the best for investors, and hence the best market structure, but Regulation NMS does not help us decide which it is. In fact, by allowing some investors and markets to trade through prices on the NYSE, and by attempting to impose the trade-through rule on the trading of Nasdaq securities, Regulation NMS further confuses the issues.

The fundamental question of market structure is whether investors are better off when securities trading is centralized in a single dominant market, or when it spread among a number of competing market centers. If the SEC is interested in reforming securities market structure it must address this question, and Regulation NMS does not do so. Accordingly, I believe the Regulation should be withdrawn until the SEC has done sufficient study and analysis of market structure to make an appropriate recommendation.

There are two basic models for organizing a securities trading system. In the first, trading in specific securities is centralized, so that to the maximum extent possible all orders to buy and sell meet each other in a central market. In economic theory, this produces the greatest degree of liquidity and thus the best prices and the narrowest spreads.

This model has two potential large-scale deficiencies: it forces all trading into a single mode—one size fits all—and thus will not meet the trading needs of some investors, and it does not create incentives for innovation or encourage accommodation to changing investor needs and demands.

The second model is a decentralized structure that contemplates competing market centers. Any security can be traded in any market. The advantages of this structure are that it can potentially meet the trading requirements of the greatest number of investors, and because the markets are in competition with one another it provides adequate incentives for innovation and change.

The disadvantage of this structure is that it breaks up liquidity and thus could potentially interfere with price discovery; it also could result in investors getting different prices for the same security executed at the same time, which some regard as unfair.

In most sectors of the US economy—other than the securities markets—the second model prevails, and in fact industry structures have been moving in that direction because of technology and the benefits of competition. The same products, from automobiles to computer software, are sold through a variety of retail outlets, including stores, websites and catalogues, at varying prices and in combination with a bewildering variety of associated services such as warranties, technical support, and money-back guarantees. No one seems to find this strange or in any sense troubling, and consumers treat it mostly as a game, boasting to friends about the bargains they were able to obtain through shrewd negotiating or extensive research.

For some reason, however, this market structure is not deemed to be satisfactory for securities trading. In the securities markets, SEC regulation has over many years attempted to protect investors against the possibility that they might not get the best price available in the market when they want to trade. This long-standing policy has been justified as assuring investors that the market is fair, or—on a more practical level—encouraging them to place limit orders in trading venues because they have some assurance that the offer will not be ignored. Because Americans seem quite content with receiving prices for identical products that differ on the basis of how much research or effort went into the purchase process, it is not at all clear that the SEC's rationale for its policy is sound. Nevertheless, that rationale is the basis for the trade-through rule, which—as discussed below—is the most significant current determinant of securities market structure.

That market structure is characterized today by only limited competition among trading venues. Although SEC officials describe the US system as one that consists of competitive markets, this is true in only two limited senses. The Nasdaq market is indeed competitive. There, many market centers vie for investor attention and trading interest, and investors are getting the benefits of the pricing and innovation that results. But this is only half the system and probably a good deal less than half the volume of daily trading in US securities. The other half consists of the trading in New York Stock Exchange-listed securities, and competition in this market is severely limited. The NYSE is a centralized market, where investors may get the benefits of concentration and resulting

liquidity, but not competition among markets. The only sense in which Nasdaq and the NYSE are competing with one another is that both of them seek listings from the same issuers. This is competition of a kind, but not competition that might provide benefits to investors.

The reason for the difference between competitive conditions in the two markets is probably the trade-through rule, which is applicable to NYSE-listed securities, but for historical reasons not to those listed on Nasdaq. The trade-through rule requires that customer orders to buy or sell NYSE-listed securities be forwarded to the market center where the best price for those securities has been posted. The purpose of the rule—in conformity with the SEC's long-standing policy—is to increase the chances that buyers and sellers of a security will get the best price available in the market at the time they want to trade, even if the security is traded in different markets.

When all markets were human-mediated, the rule did not have much effect on the market structure of, or on competition in, the markets for NYSE and Nasdaq securities. In both market centers, it was routine and expected that investors would wait for the NYSE specialist or the Nasdaq market maker either to execute a trade or to report that the trade could not be executed because prices had changed between the time the trade was sent and the time it was acted upon. However, with the rise of electronic communications networks (ECNs), the applicability of the rule in the case of the NYSE—and its non-applicability in the case of Nasdaq—had significant effects on the competitive structure of each market.

ECNs are capable of matching buy and sell orders virtually instantaneously; this is the source of their attractiveness as trading venues. Where the trade-through rule was applicable—where it was necessary to forward a trade to a human-mediated market (usually the floor of the NYSE) and wait for a decision by a specialist—ECNs cannot function efficiently or effectively. As a result, the ECNs have not been able to compete effectively for trading in NYSE securities. The liquidity and depth that has resulted from the centralization of trading on the floor of the NYSE still pulls in volume, and the trade-through rule prevents the ECNs from developing the degree of volume and liquidity in NYSE-listed securities that is required to compete effectively. As long as the trade-through rule continues to apply in the market for NYSE securities, it will not be possible to test whether ECNs provide a more efficient trading venue—at least for some investors—than the specialist system that currently prevails at the NYSE.

In the case of Nasdaq securities, however, where the trade-through rule does not apply, ECNs apparently have apparently been able to provide better overall pricing than Nasdaq market-makers. This is true even though some trades took place at prices that would—if the trade-through rule had been applicable—have required the trade to be forwarded to a Nasdaq market-maker for execution. What seems clear is that in the Nasdaq market, where there has been a real world test because of the inapplicability of the trade-through rule, ECNs offered such strong competition for Nasdaq's dealer-market structure that Nasdaq was compelled to convert itself into an electronic market—in effect, an ECN. Only in this form could it compete for trading in Nasdaq-listed securities.

The rise of ECNs is a classic example of how technological change can completely upend settled economic arrangements, and the trade-through rule is an example of how regulation can create and sustain market structures that—without it—might not have existed at all.

When the national market system for securities was first mandated by Congrss in 1975, there were a number of regional securities exchanges functioning in the United States, and Congress seems to have contemplated that they would all be in competition with one another. A comprehensive national quotation and trade reporting system would inform investors and their brokers where the best prices in specific securities were to be had, and it was assumed that trading would naturally flow in that direction.

In the normal course, if this market had been allowed to develop as other markets do, trading in particular securities would tend to centralize in a single market—just as all the auto sales showrooms, antique stores and flower shops tend to locate in the same area—because customers will go to the place where the most choices and the greatest competition among sellers are thought to prevail. All other things being equal, investors will generally place their orders to buy and sell in the market with the greatest liquidity, since that is where the chances that the trade will be executed are greatest, and where the prices are likely to be best.

This sorting out process might have resulted in a securities market structure where certain regional exchanges—say, Philadelphia or Boston—would have become market centers for specific securities or the securities of certain industries, concentrating the trading in those securities in a single place and thus producing the advantages of high liquidity. If such a structure had developed, it would have provided some of the benefits of true competition *among* markets, since the existence of potential competitors would have spurred each market to innovate and operate efficiently.

However, this structure did not have a chance to develop. The SEC—pursuing its policy of assuring that investors have access to the best price anywhere in the market—pressed for a linkage among all the existing markets that would have assured the execution of orders in each listed security on the basis of time and price priority. In other words, if an investor was the first to offer to buy 100 shares of US Steel at 30, this order would have to be executed before anyone anywhere could buy US Steel shares at 30 and 1/8.

The existing regional markets resisted this plan, and a compromise was developed, now known as the Intermarket Trading System, or ITS. In this system, each market center had reciprocal trading privileges in every other market. To meet the SEC's demand that investors always have access to the best price posted anywhere, the ITS included a "trade-through" rule, which required that orders in particular securities be sent to the market where the best price was posted. In securities market lingo, to "trade through" a price is to ignore it and execute a purchase or sale at an inferior price.

In practicality, this meant that the New York Stock Exchange, which at that time had the deepest and most liquid market in virtually all listed securities, would become the

dominant and unchallenged market for listed securities. Although interposed for other reasons, the trade-through rule had the effect—probably unintended, at least by the SEC—of eliminating the competition among markets that Congress had originally contemplated.

There is good reason to believe that in the absence of the trade-through rule ECNs would be able to provide substantial competition for the NYSE in NYSE-listed securities. One of the peculiarities of the securities markets is that they are in a sense both wholesale and retail markets. Buyers and sellers of 100 shares are mixed in with buyers and sellers of 100,000 shares, even though their needs and demands are very different. One of the principal differences is that big buyers and sellers have an effect on the price of a security, while purchases and sales by small investors do not. Even information about the trading interest of big buyers and sellers can have an effect on the market, and thus has a value in itself, while information about the trading interest of small investors has no special value.

Accordingly, the best price available for institutional buyers and sellers is far different from the best price available for retail investors. A retail investor can often buy or sell 100 or 1000 shares at a price that is better than the spread on the NYSE, but that opportunity is not available to the institutional buyer. The fact of the institutional buyer's trading interest can cause the price to rise or fall. Thus, the best price for an institutional buyer may be obtained in markets where institutions can trade anonymously, without intermediaries and without revealing the full scope of their trading interest—in other words where their trading has the least market impact. Where markets are rising or falling quickly, the ability to achieve quick execution for a large order is also a factor in whether the institutional investor receives the best price that could be obtained in the market at that time.

These examples illustrate that it is a vast oversimplification to suggest that the current dispute about market structure and the role of ECNs is a question of price versus speed of execution. Because of the material differences between the trading needs of the institutional investor and the retail investor, the institutional investor's *definition* of best price is different from that of the retail investor. To the institutional investor, the best price is the price that can be obtained with what is called low market impact. Speed of execution is a factor, too, because large orders simply cannot be filled at a single price, and the market is frequently moving away. These are not considerations that the retail investor must keep in mind, so it should not be surprising that the definition of best price for retail investors and institutional investors turn out to be different.

Thus, it appears that the current structure of the NYSE is suitable for the transactions of millions of retail investors, whose trades and trading interests do not on an individual basis have market impact, but—because it provides few mechanisms for limiting market impact—is not entirely suitable for institutional investors.

With this background, we come to the question that the SEC is now required to answer: whether, in a world in which technology has made it possible for investors—especially institutional investors—to have access to electronic trading venues, the SEC

should continue to apply the trade-through rule for transactions in NYSE-listed securities. A more general statement of this question is whether the best structure for the US securities markets is one in which there is a single centralized market like that for trading NYSE securities, or one—like the current market for Nasdaq securities—in which a variety of market centers and trading venues compete with one another.

Regulation NMS does not answer this question. Instead, it simply attempts to tweak the existing structure so as to address some of the complaints of institutional investors, ECNs and others, without considering whether its support of centralization of trading should be modified or abandoned. This approach is internally inconsistent, reflects a confusion of policy at the SEC, and fails to address the fundamental issues involved. Indeed, it has many of the aspects of dividing the baby: it seems superficially fair or evenhanded by offering each group what it seems to want, but in every real sense it does not produce a satisfactory or workable result.

For example, the Regulation would permit institutional investors and possibly others to opt-out of the trade-through rule for NYSE securities. It would also allow electronic or automated markets, under certain conditions, to trade through non-automated markets. This is clearly an effort to address the desire of institutional investors to trade NYSE securities on ECNs, but it completely ignores the traditional rationale for the trade-through rule, and the arguably beneficial effects of the rule in centralizing trading in the NYSE.

The basis of the rule is fairness; it is intended to provide an opportunity for everyone who is trading securities at a given time to have access to the best posted price available in the market. Supporters of the rule, including SEC officials, argue that investor confidence in the fairness of the market would be compromised if investors did not get the best price available at the time of their trade, or if their limit orders were ignored and traded through in some other trading venue. As noted above, in markets other than the securities market it is not unusual for buyers and sellers to find that they have not gotten the best price, and they seem to survive this information with their emotional stability intact. But if we assume that the securities market is somehow different from other markets, and that investors cannot rise above the unfairness associated with not getting the best available price at a given time, on what principled basis does the SEC exempt automated markets from the trade-through rule or allow investors to ignore the posted prices in non-automated markets by opting out of the rule? Fairness is either important or it is not.

Similarly, it can be argued that the trade-through rule protects the NYSE against the kind of competition that has reduced Nasdaq to just one of a number of automated markets competing for trading interest in its own listed securities. If so, in the view of supporters, the rule is also preventing the "fragmentation" of trading in NYSE securities that would reduce liquidity and widen spreads. If centralization is indeed a benefit, and fragmentation is a danger, on what basis is the SEC allowing automated markets to trade through the NYSE, or allowing traders to opt out of the trade-through rule and trade elsewhere in NYSE securities?

The answer to all these questions is that the SEC provides no answer, either in Regulation NMS or in the accompanying material. It seems simply to be seeking to mollify ECNs, and institutional investors who want to use ECNs for trading NYSE securities, by providing a limited opportunity to trade through NYSE prices. There is no indication in the proposed regulation or the accompanying background material that the SEC has made a judgment about the fundamental question involved—whether US investors as a group would be better off if market centers compete or better off if trading were centralized in one place.

A similar set of questions could be raised about the Regulation's proposal to *impose* the trade-through rule across the board to all NMS securities, including Nasdaq securities. What evidence is there that the absence of a trade-through rule in the Nasdaq market—and the migration of trading to ECNs—has harmed investors in Nasdaq-listed securities? Is there evidence that investors who have been traded-through are disgruntled or disheartened, or that they are no longer placing limit orders on ECNs or with Nasdaq market-makers? If there is no evidence that these things are happening, why impose the trade-through rule where it is not already applicable? The reason can't be the usual reason for support of the trade-through rule—that it is necessary to assure investors of fairness and access to the best prices. That reason has already been given away by the SEC's proposal in the Regulation to allow an opt-out for some investors and an exemption for automated markets. Nor can the reason be that the SEC wants to centralize trading in Nasdaq securities; the opt-out provisions in the Regulation preclude that.

Although it would be tempting to do so, the Regulation cannot be viewed as an experiment. If it were, it would not have been proposed as a regulation. A proposed regulation can be put into effect after the comment period and is permanent until modified or withdrawn. Market participants act in reliance, assuming that the regulation will not change. When the SEC has done experiments, as it has several times in this area, it describes them as such, and notes that they are temporary.

Some experiments might have been helpful in framing a regulation that effectively addresses the central questions of market structure. For example, the Commission could have selected a sample of NYSE-listed securities, and permitted investors to opt out of the trade-through rule with respect to those securities, or permitted automated markets to trade through non-automated markets in trading those securities. The overall effect on investors could then have been assessed. Was the result substantially to reduce liquidity and increase the spreads in those securities? Did some investors in fact find pricing so much better on the ECNs that they moved substantial amounts of their trading to automated markets? The answers to these questions might have provided the SEC with some of the data necessary to make a judgment about whether the trade-through rule should continue to apply to the trading in NYSE-listed securities, and whether or not a market consisting of competitive market centers is better for investors than a centralized market.

Thus, the only apparent rationale for Regulation NMS is that the SEC is temporizing. The agency has no answer to the question whether centralization of trading is better than competitive market centers—although this is the fundamental point at

issue—and no plan for finding an answer. Instead of doing nothing, it is proposing a regulation that will keep everyone engaged in the debate. By permitting some investors to opt out of the trade-through rule, and exempting automated markets from the rule in certain circumstances, the SEC is suggesting that it thinks competing market centers are good policy and that the fairness issues traditionally associated with the trade-through rule are not important anymore. On the other hand, by applying the trade-through rule to trading in all NMS securities, the SEC is suggesting just the opposite—that fairness is important and enhanced competition between market centers is not. In other words, Regulation NMS is less than a half-measure; it leaves the major issues of securities market structure unexplored and unresolved.

Accordingly, there is a complicated answer to the question of how investors will fare if Regulation NMS is adopted as proposed. Because it does not resolve the basic question whether securities trading should occur in a centralized market or in multiple market centers that are competitive with one another, Regulation NMS—if it is imposed at all—will inevitably be only a temporary stopping point.

Because I believe that competitive market centers will provide the most choices for investors and ultimately produces the most efficient markets, I expect that the Regulation's opt-out provisions and its exemption for automated markets—if they go into effect—will over time cause substantial amounts of trading in NYSE securities to move to the ECNs. On the other hand, the imposition of the trade-through rule on trading in Nasdaq securities will not have much effect, since most participants in the automated Nasdaq market already commit to forward customer orders to other market centers where they can be immediately executed.

Under these circumstances, for competitive reasons, the NYSE will eventually elect to become an electronic market, and will privatize for this purpose. Investors will fare better, overall, in this environment than they will in the current system, but the transition from the current structure to a structure consisting entirely of competing market centers will be messy and costly to all concerned. To avoid this, it would be far better for the SEC to step back from Regulation NMS and consider the fundamental issues involved—running experiments and doing analysis before leaping ahead with a poorly-considered and temporary plan.

Mr. Chairman, that concludes my testimony.

Statement of Daniel G. Weaver, Ph.D.
before the
Subcommittee on Capital Markets, Insurance, & Government Sponsored Enterprises
May 18, 2004

I have taught market microstructure since 1980 and have over 25 published articles most of which examine the impact of rule changes on markets. I have done work on market transparency, tick sizes, and consolidation rules, among other topics. My work has been presented at academic and professional meetings around the world. I have regular dialogs with a number of securities exchange leaders both domestic and foreign. The press routinely consults me as an expert on market microstructure. Therefore, I feel I am well qualified to opine on the proposed market regulation changes.

Let me state unequivocally that I am against the repeal of the trade through rule. If the rule is repealed, it will further fragment our markets and hurt investors. It would be a large step backward in the modernization of US markets, effectively taking us back to pre-Manning Rule days. The history of the Manning Rules has reverse parallels to the proposed repeal of the trade through rule. Prior to Manning I (enacted in 1994), NASDAQ dealers could simply ignore customer limit orders. Customers learned that limit orders were not executed and did not submit them. Manning I prevented NASDAQ dealers from trading through customer limit orders at better prices – much like current trade through rules do today. However, after the passage of Manning I, NASDAQ dealers could still trade at the same price as customer limit orders they held – that is there was no public order priority rule. Customers were still reluctant to submit limit orders. Manning II gave public limit orders priority, but only within a dealer firm. In other words, a customer submitting a limit order to Dealer X could still see trades occurring at other dealers at the same price as the customer's limit order. Thus, Manning II still discouraged public limit order submission.

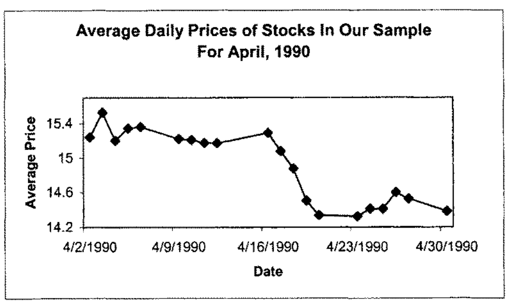
It took the Order Handling Rules (OHR), enacted in early 1997, to unleash the potential of public limit orders. After the OHR, spreads dropped dramatically. ECNs which display customer limit orders grew in market share from around 20% to 80% today. ECNs allow public limit orders to compete with NASDAQ market maker quotes. The lesson is clear. If limit orders stand a chance of execution, they will be submitted and can then become an important source of liquidity for markets.

Limit orders are shock absorbers for liquidity events. Without limit orders to absorb trades

from liquidity demanders, large orders will increasingly push prices away from current prices.[1] While it may be argued that price impact is a fact of life for institutions, I am more concerned about the small trader that submits an order in the same direction, but just behind the large order. The small order will execute at an inferior price before sufficient liquidity can be sent to the market by traders. It can then be seen that thin markets are more susceptible to liquidity event volatility than deeper markets.[2]

Repeal of the trade-through rule then will take us back to pre-Manning Rule days. It will discourage limit order submission and in turn increase volatility in affected stocks. This will result in higher effective execution costs for the average investor. A few large players will benefit, but it will be at the expense of the majority of long term investors. It has been shown, time and time again that investors factor execution costs into their required cost of supplying funds to firms.[3] Therefore, higher execution costs will translate into higher costs of capital for firms and stock prices will fall. This will make it more difficult to raise capital and hence provide a drag on the economy.

The figure below illustrates the relationship between execution costs and stock prices.[4] On April 11, 1990 the Toronto Stock Exchange enacted rules that resulted in effective execution costs rising by about 0.25 percentage points. Within a week, prices declined by over 6%.



[1] Assume that there are 100 shares offered at $19, 200 at $19.05, 100 at $19.10, and 300 at $19.15. A market order to buy 500 shares will take out the sell orders from $19 to $19.15, leaving the best offer at $19.15 until new offers to sell arrive. This is sometimes referred to at walking the book.
[2] Assume a deeper market of 600 shares offered at $19. Then a 500 share order will not move the price.
[3] See Y. Amihud,, 2002. Illiquidity and stock returns: Cross-sectional and time-series effects. Journal of Financial Markets 5, 31-56; Y. Amihud, and H. Mendelson, 1986. Asset pricing and the bid-ask spread. Journal of Financial Economics 17, 223-250; and Y. Amihud, H. Mendelson, and B. Lauterbach 1997, Market microstructure and securities values: evidence from the Tel Aviv Stock Exchange. Journal of Financial Economics 45, 365-390; among others.
[4] Source A. Madhavan, D. Porter, and D. Weaver, 2004, Should Securities Markets be Transparent?, forthcoming, *Journal of Financial Markets*.

The above impact on prices will likely happen if the trade through rule is repealed. It will set us back 10 years and put us dead last in the modernization of markets among industrial nations. Other nations have seen the value of routing orders based on price. The Toronto Stock Exchange effected rules that require brokers receiving market orders of 5,000 shares or less, to either improve on price or send the order to the TSE for execution against limit orders. Following that action, the affected stocks experienced an immediate increase in depth and reduction in spread.[5] Evidence from US markets finds the same result. When Merrill Lynch decided to stop routing their orders to regional stock exchanges, spreads narrowed and customers obtained better executions.[6] Recently, the EU passed Investment Service Directive 2, which is similar to the TSE concentration rules.

The above are examples of the adage that "liquidity begets liquidity." In other words, limit order traders will submit limit orders where market orders are. It is similar to the fact that the more traffic exists on a highway, the more gas stations will exist. If the traffic goes away, so will the gas stations. Similarly, if market orders get routed away from the venue with the best price, limit orders will leave that venue as well. Going back to the gas station example, it doesn't matter how cheap your gas is – you won't sell much at the back of a dead end street.

If markets want to compete they should do so on price which is the current structure. However, the entire notion of markets competing is problematic. True competition is between natural buyers and sellers. I doubt if any member of the public has ever received a call from the Chicago Stock Exchange asking them to send their orders for NYSE listed stocks there – but their brokers certainly have! We all know the problems associated with preferencing of order flow. There are those that argue that it discourages price competition since quoting better prices does not result in more order flow. Allowing orders to be routed for reasons other than best price will increase the incidence of preferencing – again taking a big step backward in efforts to modernize our markets.

I am generally against allowing traders to give blanket opt-outs of the best-price rule. Most investors don't know their bid from their ask, and I am afraid will quickly agree to allow their brokers to opt-out their accounts. This opens the flood gates to abuse by brokers, undoing years of regulatory mandated improvements in our markets. There may be something to be said for allowing *some* traders to make an informed decision to opt-out on a trade by trade basis. I can see Fidelity opting out of the trade through rule for a trade to sell 50,000 shares of IBM immediately.

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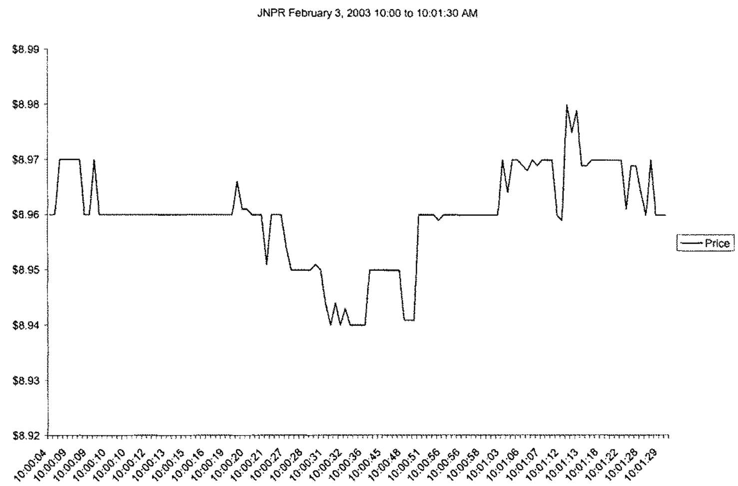
[5] See A. Murphy, Financial Market Consolidation Versus Fragmentation: A Comparative Analyis, unpublished Working Paper, Manhattan College.

[6] See R. Battalio, J. Greene, and R. Jennings, 1998, Order Flow Distribution, Bid-Ask Spreads, and Liquidity Costs: Merrill Lynch's Decision to Cease Routinely Routing Orders to Regional Stock Exchanges, *Journal of Financial Intermediation* 7, 338-358.

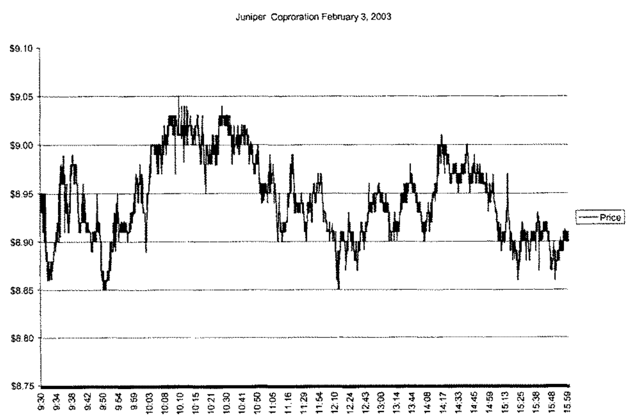
However, I would suggest that this can be accomplished through changes to the rule for block trades. Therefore, I don't really see a need for an opt-out ability. If enough investors opt-out, then market orders will be routed away from current venues and executed at inferior prices. This will discourage limit order traders from providing liquidity, leading to more volatility in the markets, higher execution costs, and higher costs of capital for US firms.

Repealing the trade through rule in listed markets will result in fragmentation similar to that on NASDAQ. The fragmentation of NASDAQ has led to an increased usage of order routers to find liquidity. The creation and sale of order routers is perhaps the biggest growth segment of the securities industry today. Companies like ITG do a big business selling trading firms their order routing services. Now, these order routing developers are not charitable organizations, but for-profit. Therefore, it costs money to find liquidity in the OTC market today. This further adds to execution costs. The traders who need order routers are those that trade frequently – a hedge fund rather than a shopkeeper in New Orleans. Perhaps some brokers will get them as a way to attract clients, but they will have to pass this cost along in the form of higher commissions – again increasing execution costs for the average investor. Therefore, increasing the fragmentation of markets, by allowing opt-outs of the trade through rule will result in higher execution costs - because of the increased cost of finding liquidity.

The most common reason cited for wanting to opt-out of the trade through rule is a desire to get a trade done quickly – perhaps in a second or less. Is this advantageous? Perhaps examining a graph of a random stock on a random day would help. Below is a graph representing all trades in JNPR for February 3, 2003 from 10:00 AM until 10:01:30 AM



It can be seen that getting an order filled at 10:00:51 compared to 10:00:52 may save you $0.02 on that trade. However, if we examine JNPR over the entire day



it can be seen that prices fluctuated by $0.20 over the day, a factor of 10. So price changes over small time increments are much smaller than over longer increments. Then, what type of trader benefits from small price changes and hence need speed? Arbitrageurs and hedge funds. As mentioned earlier, if we allow orders to be routed for other than best price, then limit order traders will reduce the amount of liquidity they supply, increasing execution costs. It can then be seen that this "need for speed" benefits the few at the expense of the many.

With regard to the **proposed ban on sub-penny quoting**, I was one of a number of academics that testified before Congress in support of decimalization. I wish to point out that decimalization does not mean penny ticks – it means quoting in dollars and cents. For example, the Toronto Stock Exchange "decimalized" and adopted nickel ticks for stocks trading above C$5. As studies have shown a small tick encourages stepping-ahead and thus again discourages traders from placing limit orders. These traders do not necessarily exit the market. They merely switch to using market orders and monitor the market more closely – sending in additional liquidity as conditions become favorable.

While it is true that a lower tick will reduce spreads on *some* stocks, this improvement in spread must be balanced against other market quality measures such as depth. Small traders do not necessarily benefit from a narrower quoted spread because increased price volatility may cause an increase in effective spreads. Therefore, I am in favor of a significant tick which balances spread width improvement against liquidity provision. Banning sub-penny quoting ***and trading*** will encourage placement of limit orders since it makes stepping ahead more costly. It will lead to more depth and lower overall execution costs.

The Public Advocate for the City of New York

Betsy Gotbaum
Public Advocate

Ref: File # S7-10-04

May 3, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Dear Mr. Katz,

I am writing to you in support of a basic principle: the right of investors to obtain the best price at all times. It is a right that seems so intuitive it should scarcely need to be defended. But, as you know, there are four interrelated proposals presently pending before the Commission which threaten to remove the obligation that those purchasing or selling stock always do so at the best available price.

As a citywide elected official, I represent more than 8 million New Yorkers, and advocate on their behalf. It is clear to me that this rule change would materially harm their interests. Investors deserve to know that at all times, under all circumstances, those executing trades on their behalf will do so at the best available price. Removing that assurance would undercut confidence in the marketplace, a singularly grave prospect.

I also serve on the board of the New York City Employees' Retirement System (NYCERS), one of the nation's largest public pension funds. I am disturbed by the notion that these proposed changes could weaken the protections afforded to investors, and feel that it is my fiduciary responsibility to voice my objection to the plan.

I am convinced that the best price ought to be offered to investors. I hope that you will preserve the National Market System as it was intended to be –electronically linked exchanges that provide for broader, deeper, and more liquid capital markets. I appreciate your taking the time to consider this letter, and look forward to learning of your decision.

Sincerely,

Betsy Gotbaum

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USA TODAY
February 26, 2004, Thursday, FINAL EDITION

SECTION: NEWS; Pg. 12A

HEADLINE: Trading-rule change cheats investor

Individual investors deserve to get the best price when they -- or the institutions representing them -- invest their hard-earned funds in the stock market. The Securities and Exchange Commission is considering proposals to give up investors' right to the best price ("SEC may change best-price trading rule," Moneyline, Money, Tuesday).

As one who represents individual investors, I think it's wrong for market professionals and executives of the institutions promoting this proposal to break their trust with their own customers, in an effort to increase their profitability.

Research on this subject will not surprise anyone. Individual investors don't really know or understand the details or complexity of the issues involving the "trade-through" or "best-price" rule. They never worried that the institutions they entrusted with their money, and the government agency that is supposed to protect them, would be proposing the elimination of a requirement that assures the real investor of getting the benefit of the best price when buying or selling the stock of companies listed on the New York Stock E Exchange.

One proposal to let institutions "opt out" of the rule that provides the real investor with the best price is totally antithetical to everything that Congress and the SEC have done to improve trust in the markets. Calls for increased speed recently have been addressed by the NYSE, thereby eliminating the only argument that had even minimal merit. To eliminate the best-price rule would do nothing but further weaken the integrity of the markets and the increasing trust in our regulators.

Individual investors may not yet understand what is being contemplated, but if they are, once again, ignored in favor of large institutions, it would undermine much of what all the exchanges, regulators and Congress have done to rebuild their trust.

During the SEC's forthcoming comment period, I urge individual investors to protect their right to the best price by asking the SEC to keep the best-price rule in place.

Kurt Stocker, NYSE Individual Investor, West Cliffe, Colo.

Response to question from Congressman Fossella

Question: "Suppose for a minute the opt-out rule is adopted . . . what impact will the lack of having someone stand in and fill that negative obligation have on the marketplace and the retail investor?"

Congressman Fossella paints a scenario in which an order "can't be filled on an electronic exchange due to lack of liquidity," although no such scenario ever exists. There are always continuous bids and offers on NYSE-listed stocks on electronic markets, such as ArcaEx and INcT. If these prices are worse than those the investor believes he or she can obtain on the NYSE, the investor will send the order there instead.

But Congressman Fossella then worries that if the NYSE specialists "disappear from the picture" the investor will suffer, because no one will "have an obligation to fill the order." But specialists have no obligation to buy or sell at any particular price. Their "obligation" is only the broad one of maintaining a fair and orderly market, which most of the time they fulfill merely by allowing public orders to interact.

Moreover, the $241.8 million in fines recently agreed to by five of the seven specialist firms, for improper discretionary trading, is testimony to the fact that specialists are frequently *not* "buying when there are no buyers," but rather buying *in front of* public buyers and profiting at their expense. Given that specialist franchises are not charities but businesses (and historically very profitable ones at that), it should not be surprising that they should prefer to buy when prices are going up rather than when they are going down.

A recent study by Kenneth Lehn *et al*[1] found that spreads on NYSE stocks increase significantly more than they do on Nasdaq stocks during stress periods, after controlling for attributes of NYSE and Nasdaq stocks that are associated with spreads. The study further found that Nasdaq market makers behave much like NYSE specialists during stress periods – that is, their spreads widen considerably – so that the strong relative performance of Nasdaq during stress periods is accounted for by ECNs. Since ECN spreads are determined by natural buying and selling interest from investors, and not mandatory quotations by intermediaries, this finding should indicate that neither specialists nor market makers offer any free lunch when liquidity is poor.

Benn Steil
Council on Foreign Relations
June 4, 2004

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[1] Lehn, Kenneth, Sukesh Patro, and Kuldeep Shastri, "Information Shocks and Stock Market Liquidity: A Comparison of the New York Stock Exchange and Nasdaq," paper presented at the American Enterprise Institute, June 9, 2004.

Reply to Congressman Fossella

By Peter J. Wallison
Resident Fellow
American Enterprise Institute

Question: Suppose for a minute that the opt-out rule is adopted and a significant amount of trades are taken off the floor and internalized or executed electronically. As Mr. Bang points out, more trades will be executed electronically, and trades that can't be filled on an electronic exchange due to lack of liquidity, will be sent to the NYSE for the specialist to fill since they have an obligation to fill the order. Assuming the specialist's argument that they won't be able to sustain a business model in this environment, and they do disappear from the picture, what impact will the lack of having someone stand in and fill that negative obligation have on the marketplace and the retail investor?

Reply: There are three responses to this hypothetical situation:

1. Although there is great and justified concern about the "retail investor," it's not clear who this person is. The great majority of all American families own stock, but most of this ownership is through mutual funds and pension funds—the institutional investors who have been asking for more freedom to use the electronic exchanges to trade NYSE securities. Thus, lowering the costs of trading for these institutional investors—if that could be attained through electronic trading—would be a great benefit to these retail investors. Although I don't have the figures available, I would guess that the "retail investors" who trade for their own accounts are a relatively small group, including day traders and wealthy individuals, both of whom are sophisticated enough about the operation of the markets not to require the special protections which the Congressman assumes are associated with trading on the NYSE under the current system. If we have to make a choice between continuing to assist this group, or to reduce the costs for the millions of American families on whose behalf the institutional investors are trading shares, it would seem that the better policy would be reduce the costs for institutional investors.

2. The underlying assumption of the question is that, if institutional investors are free to trade NYSE securities in the electronic exchanges, they will do so. This may well be true, and if so it calls into question the assumption on which the question is based. Institutional traders would trade on the electronic exchanges if—overall—they will get better prices there. Speed of execution is not the goal, and never was. The goal of institutional investors has always been to get the best prices when they buy and sell shares, and by and large they have found that they can do this most effectively in the electronic markets. If in fact the electronic markets were characterized by low liquidity—as the question posits—institutional investors would not trade there. In fact, that's what would cause low liquidity. Accordingly, there is little reason to worry that institutional investors will leave

the NYSE unless it does not offer best environment for trading shares—and if it does not, there is little reason to continue to support that market with regulations.

3. More companies are listed on the Nasdaq than are listed on the NYSE, and Nasdaq does not have specialists with an obligation to buy or sell shares. Nasdaq market-makers fill the role of specialists on the NYSE, but do note have an obligation to make a market. Nevertheless, a recent study done for AEI by professor Kenneth Lehn and colleagues at the Katz School of Business at the University of Pittsburgh shows that—in periods of market stress—volatility in prices is lower for comparable stocks on Nasdaq than on the NYSE. This suggests either that the NYSE specialists are not performing the function they claim to be performing or that an electronic, competitive market like Nasdaq does not need specialists in order to remain orderly in times of stress. It would also suggest that concerns about liquidity outside the NYSE are unfounded.

Response of Daniel G. Weaver, Ph.D.

To Congressman Fossella's Question to the Entire Panel

Regarding Testimony Before the

Subcommittee on Capital Markets, Insurance, & Government Sponsored Enterprises

May 18, 2004

Specialists play a very important role in markets. The market correction of October 1987 clearly illustrates the difference between NYSE specialists and NASDAQ market makers. Specialists continued to supply liquidity while market makers took their phones off the hook and walked away. There are two basic types of markets in the world today – order driven and quote driven. In a quote driven market such as the pre-1997 NASDAQ, dealers provided liquidity to the market through offering to buy and sell stocks. This is similar to a produce market where dealers buy wholesale and sell retail. However in stocks we call it bid and ask.

The other form of market is order driven. This was, until recently, the predominant form in Europe. In an order driven market, limit order traders supply liquidity to the market. Because there is no one charged with maintaining an orderly market, there are many instances of quotes being very wide or only having only one side (i.e., a bid but no ask or visa versa). To keep markets from running away, these markets impose daily price limits on price movements for each stock (e.g., stocks may not be allowed to deviate from the previous day's close by more than five or ten percent).

Because of the problem of wide spreads and/or one sided quotes, markets around the world have discovered that specialists add to the trading system and as a result more and more markets are adopting a hybrid market system. In such a system, limit orders are supplemented by a specialist, i.e., the NYSE model. A recent paper by Professors Steve Mann, Kumar Venkataraman, and Andy Waisburd entitled "Stock Liquidity and the Value of a Designated Liquidity Provider: Evidence from Paris

Euronext" finds that the adoption of a specialist system for stocks prevents market failure. I myself (along with Professors Amber Anand and Carsten Tanggaard) have studied this issue in a paper entitled "Paying for Market Quality." In that paper, we examine the 2002 decision by the Stockholm Stock Exchange to allow listed firms to contract to obtain specialist services. It is important to point out that listed firms pay a fee in addition to the exchange listing fee to obtain these services. We find that after contracting with a specialist, percentage spreads declined by half and quoted inside depth increased by half. This improvement in trade terms was accompanied by a tripling of trade volume. This was obviously money well spent by Stockholm's listed firms. In fact the initial success of the system has caused the number of listed firms using it to triple since 2002. It has also lead to the adoption of a similar system by the Copenhagen and Helsinki Stock Exchanges.

Therefore, while other countries are discovering that modernizing their markets points to adopting a specialist hybrid system, we are considering rules that may put that system in jeopardy. Allowing markets to fragment by eliminating price priority will result in wider spreads for average investors and a higher cost of capital for listed firms.

I also want to address the idea of "competing specialists" that markets such as the Boston Stock Exchange and others employ. In my opinion, these specialists do not compete at all. They are disguises for internalization thought up before the repeal of Rule 390. This rule required that NYSE members had to execute trades for stocks listed on the NYSE before 1975, on a stock exchange. This meant that members could not internalize the trades through their NASDAQ membership. "Competing specialists" allowed NYSE members to establish a specialist post on a regional exchange and route orders to their captive specialist – effectively internalizing the orders.

THE NYSE has the best price over 90% of the time. We say we want markets to compete. Let them compete on price. Why create a welfare system for ATSs that exempts them from competition?

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